LOUISIANA BAR JOURNAL

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LOUISIANA BAR JOURNAL

Published Quarterly by The Louisiana State Bar Association

Volume II JANUARY, 1955 No. 3

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Entered as second class matter at the Post Office at New Orleans, La., under Act of March 31, 1879.

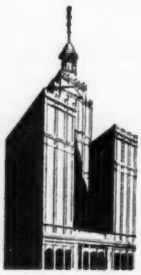
A LAWYER'S FEE IS A WISE INVESTMENT

IF you write your own will to save the fee that a lawyer would charge for drawing it, you save a few dollars—and it may later cost your family many times that fee.

Your "home-made will" may be declared invalid by the court. Then your estate will be distributed in the way the intestate law provides, perhaps depriving your wife of part of your property.

Your "home-made will" may transfer your estate to your family in the most expensive way, exposing it to unnecessary taxes and administration costs. An attorney, on the other hand, can probably suggest a more economical method of transfer that may save hundreds of dollars for your family.

Do not risk so much to save so little. If you have written your will, ask *your attorney* to read it. If you have not made a will, have him draw it now.



The Hibernia National Bank

IN NEW ORLEANS

This is the type of Trust Department advertising this bank is addressing to the public.

A Message From The President

By Thomas W. Leigh, Monroe,

President of The Louisiana State Bar Association

The half-way point of your Association's current year has been reached and passed. One more issue of Volume II of the Journal remains after the present one, and thereafter the responsibility for filling this page will pass into other hands.

This particular message is being written on the eve of our Fourth Annual Mid-Winter Conference, which is scheduled to be held in Shreveport on Friday and Saturday, January 28-29. The Conference this year is being sponsored by the Sections on Insurance and Taxation in addition to the Junior Bar Section and the Section of Local Bar Organizations, and the Committees on Public Relations and Legal Institutes which have sponsored these meetings in the past. The Shreveport Bar Association is host at this meeting, with the general arrangements being in charge of Mr. Philip Goode and Mr. Marlin Risinger, Jr., as Co-Chairmen. An interesting program has been arranged and the advance registration indicates that the attendance at this meeting will be larger than ever before.

Justice Sam A. LeBlanc of our Supreme Court retired on December 31st last, after thirty-four years of service on the bench. Your State Association sponsored ceremonies which were held on December 17th, honoring Justice LeBlanc upon the occasion of his retirement and acknowledging his long and valuable services on the bench.

The vacancy on the Supreme Court occasioned by Justice LeBlanc's retirement had been filled by the election thereto of Judge James D. Simon of the Sixteenth Judicial District. Justice Simon was sworn in on January 1, 1955 and was formally inducted into office on January 7th with appropriate exercises which were also sponsored by your State Association.

The Louisiana State University Law School's Third Annual

Mineral Law Institute is scheduled to be held in the Law School Auditorium on February 11-12. The advance program which has already been mailed out provides assurance that this will be one of the most interesting and useful of these institutes which has yet been held. The indications are that this year's institute will attract an even larger attendance than has its predecessors.

Our members are reminded that your Association's annual meeting will be held at the Buena Vista Hotel in Biloxi again this year, in conjunction with the annual meeting of the Louisiana State Law Institute. The convention will follow last year's pattern, with registration beginning on Sunday, May 1st, with business sessions scheduled to open on Monday morning, May 2nd, and continue to noon on Wednesday, May 4th.

A Hotel Reservations Committee has been appointed, from whom you will shortly receive full information as to hotel accommodations. It has been decided to ask again this year that each member accompany his request for hotel reservations with a deposit of $15.00 to be used in defraying entertainment costs, with the undertsanding that such deposit will be returned if cancellation is received at any time up to April 23rd.

Mr. Loyd Wright of Los Angeles, President of the American Bar Association, has accepted an invitation to address the convention, as has also Mr. Leonard E. Read of New York, President of The Foundation for Economic Education, Inc. Both of these are nationally known speakers and I am sure that they will add much to the enjoyment of our business sessions.

You will in due course receive more detailed information as to the convention plans. In the meantime, I hope that as many of our members as possible will plan to attend.

Subleases— The Legal Relation Between The Lessor, Sublessor and Sublessee

By Leslie Moses, Louisiana Bar

Delivered at Biloxi, May 4, 1954, Section on Mineral Law

In Louisiana the lessee of an oil, gas and mineral lease has the power and right to transfer the interest he acquired, either in whole or in part, unless the lease itself specifically prohibits such a step. Such right is recognized in the following codal article:

> "2725. The lessee has the right to underlease, or even to cede his lease to another person, unless this power has been expressly interdicted."

The word "underlease" means "sublease" and the word "cede" means "assign." This article of the code is the basis upon which the early decisions of our Supreme Court justified their recognition of two different modes of transfer, to-wit, by assignment and by sublease. The first case involving such a differentiation was one of landlord and tenant relationship concerning the leasing and subleasing of a building. In Audubon Hotel Company v. Braunnig the Supreme Court said:

> "The sublease is a new contract. The old lease does not pass to the subtenant. The lessor is not a party to the sublease and the subtenant is not a party to the original lease. There is no contractual tie between the subtenant and the owner, or lessor."

Here, lessor entered into a written contract of lease with lessee and lessee, in turn, entered into a separate and distinct written contract of sublease with the sublessee. There was no transfer, even partially, of the original lease between the owner of the building and the sublessor. The court pointed out that in a landlord and tenant relationship the lessee of the original lease

stands between the sublessee and the original lessor, to the end that the subtenant must address himself to his lessor, the original lessee, in order to assert his rights. While the court applied the reasonings of the French commentators in arriving at its decisions, they do not differ from the common law rule applicable to landlord and tenant relationship. This common law rule has been stated by Tiffany in his treatise on Real Property, thusly:

> "The sublessee is not in privity of contract with the head landlord, since there are no contractual relations between them and he is not in privity of estate with him, since there is no relation of tenancy between them and he merely holds possession for the lessee."

When oil and gas leases came into being, both in Louisiana and elsewhere, a means of transfer had to be evolved to permit and facilitate ease of disposition. The single sheet stock form of "assignment" was a result. It is well recognized that oil companies, in blocking areas, are not desirous of having their plans known to the general public and as a result, leases and lease blocks are necessarily taken in the name of third parties and thereafter transferred to the beneficial owner. Consequently, the bulk of commercial leases now in common useage in Louisiana contain express provisions giving the lessee the power and right to transfer his interest either in whole or in part.

This right expressly provided for in the lease has been construed as giving the lessee of an oil and gas lease the privilege and power to transfer his interest into third parties either by way of assignment, partial assignment, or sublease. When Smith v. Sun Oil Company came before the Supreme Court there was little jurisprudence on matters involving oil and gas and the construction of an oil and gas lease. This case involved the transfer by a lessee of a portion of the leased acreage to a third party. Production was found on one portion and the original lessor sued to cancel the lease as to the other portion because of lack of development on it. Counsel for lessor argued that the transfer was an assignment and had the effect of dividing the original lease into two separate leases, so that production on one portion did not maintain the lease as to the other portion.

Counsel for the defendant argued that the transfer was a sublease, not creating two leases so that production from any portion of the original lease maintained the entire lease in force. The court held the transaction to be a sublease and not an assignment, in that the original lessee did not dispose of all of its rights and obligations, but granted to its transferee an interest less than it owned; and, further, imposed upon the transferee obligations in addition to those contained in the original lease. The transfer further reserved in the transferor an override on the tract transferred.

The court based its reasonings on the same French commentators quoted in the Braunnig case in their discussion of Article 1717 of the French Code Civil. The French Commentators, Marcade, Moulon, Beaudant, Aubry et Rau, and other, were copiously cited at length, they having given considerable study to the difference between an assignment and a sublease in their study of Article 1717 of the Code Napoleon, from which our codal article was bodily lifted. Those quotations, when analysed carefully, show that the distinction created was a distinction based upon and peculiar to the leasing of houses, building and farms; for example, when they discuss at length the privilege that a lessor has on the moveables owned by a lessee or a sublessee, it cannot conceivably be believed that such discussion could be passed to an oil and gas lease; nor can we, by analogy, extend their other comments to the oil and gas lease. It is self-evident that those ancient precedents which formed the basis for the decision in the Sun case, were all landlord and tenant matters.

In addition, Article 2725 of our Code comes under Title IX of the Code, which bears the caption "Of Lease." Chapter 2 of this title bears the caption "Of Letting out of Things." The first article of Chapter 2, 2626, reads as follows:

"The letting out of things is of two kinds, to-wit:

1. The letting out of houses and movables.
2. The letting out of predial or country estates."

Here again is proof that our codal articles were adopted solely with respect to landlord and tenant relationship and cannot be and should not be strictly construed if they are to be applied to matters affecting oil and gas leases.

The discovery of oil in Louisiana found no mining laws whatsoever in the state. In Spence v. Lucas, decided in 1915, the Su-

preme Court admitted that mining was a new industry in the state. In Rives v. Gulf Refining Company the court said that the Code was silent as to mineral leases "for the reason doubtless that minerals under and within the soil of Louisiana were not in the contemplation of the lawmakers at the time that the Code was adopted." In this case the court went on to say: "The legislature up to this time has been silent on the subject of mineral rights and contracts. The law with reference to sales and leases found in the Code, cannot be applied unreservedly to these contracts." Again, in Natalie Oil Company v. L.R.&N. Company, the court said that the difficulties with the articles of the Code were that they were framed at a time when the nature and existence of oil under the soil of this state was not supposed or known, and laws were not framed thereafter to meet such changes and the conditions surrounding them.

These older cases all recognized the inherent difficulty presented by a contract, such as an oil and gas lease which "partakes of the nature both of a lease and of a sale. They are a part by themselves. There is scarcely any comparison between them and the ordinary farm or house lease." They partake of a lease insofar as concerns the reciprocal personal obligations of the parties and of a sale in that the grantee possesses unlimited power to deplete and destroy the principle element of the property. That is, he can consume by use that which gives the property value. In Nabors Oil and Gas Company v. Louisiana Oil & Refining Company the court observed "such a contract (meaning an oil and gas lease) is more like a sale than an ordinary lease." In Shaw v. Watson, the Supreme Court was again faced with the issue whether or not principles applicable to ordinary leases should be applied to oil, gas and mineral leases. The court said:

> "It is argued that a transfer of landowner's mineral rights, either in whole or in part, whether in the form of a sale or lease, is nothing more than imposing an incumbrance upon his land, like a mortgage or an ordinary lease for occupancy or cultivation. Our opinion is that a landowner's sale of his mineral rights cannot be compared, in that respect, with mortgaging his land, or subjecting it to an ordinary lease for occupancy or cultivation."

The courts recognized the lack of laws necessary to meet the changes and conditions which arose out of the discovery of oil and gas in the state. The lawmakers, however, were and still are lax in their dealings with problems of oil and gas. The attempt to adopt a Mineral Code met with failure in 1938 and it is not my place here to plead for the reconsideration of such a code. I must point out, however, that the continued application of landlord and tenant rules to oil and gas leases can lead to consequences far beyond contemplation. While the interpretation of contracts of oil and gas leases have heretofore had to be based upon such articles of the Code as could be applied by analogy, the end results are not satisfactory. The courts have been forced to make their own law, which has resulted in that line of jurisprudence which commenced with the Sun case and followed through in Johnson v. Moody, Robinson v. Pioneer Oil and Gas Company and others down to the most recent expression of the Supreme Court in Wier v. Glassell. As a result of these decisions it seems to be fixed in our law that an assignment, per se, of a mineral lease is the conveying of all or a part of the entire lease for the whole unexpired term, wherein the assignee secures the same interest that his assignor had at the time of assignment. It seems further to be fixed that any instrument transferring less than that, or a part of the lessee's right or obligation under the original lease, is a sublease. Accordingly, regardless of whether an instrument is labeled "assignment" or "sublease," the nature of the instrument itself governs what it is and not the name arbitrarily placed upon it by the parties to it. The word "sublease" is rarely used in the oil industry because the proper connotation thereof gives rise to the thought that there is no privity of contract between the original lessor and the transferee. It is my opinion that insofar as oil and gas leases are concerned, such an idea is fallacious.

It should be pointed out, in passing, that the distinction between an assignment and a sublease, insofar as applied to oil and gas leases, is well recognized in common law states. The Louisiana cases have been quoted with approval by the courts of many other states, including Oklahoma, Montana and California. In Texas the distinction between the two is recognized as a general proposition, but it has never been applied to oil and gas leases and transfers because under the Texas rule an oil and gas lease is not really a lease and does not create any landlord and tenant relationship.

Despite the similarity in views between the common law and our Louisiana law with respect to what constitutes the difference between the two modes of transfer, the common law does not follow through with the *sole* resulting effect of that difference as applied in Louisiana. Only in Louisiana have the courts held that as a result of such difference, the legal position of an assignor is not the same as the legal position of a sublessor, with respect to development. Only in Louisiana have the courts held that development under a sublease enures to the benefit of the entire leasehold estate, while development under an assignment enures to the *sole benefit* of he who has developed his tract. In the common law states it has been held that regardless of the mode of transfer, development on a portion of the original leased premises will hold the entire leased premises.

The reason for this difference in Louisiana has never been explained. Certainly the French authorities contain no reasoning upon which such a differentiation could be predicted. It can only be surmised that here, again, the court, facing a problem never before presented to it and having no codal or legislative provision to refer to, laid down a precedent which has become so far reaching in its effect. One can but guess that in the sublease, the lease was not divided, and so development on any portion of the leased premises was still development for the benefit of the entire lease. On the contrary, where an assignment was given, it having created two separated leases, development of one could not hold the other. This particular phase of the distinction between the two types of transfer is not based upon landlord and tenant provisions of the code, but on the contrary, seems to be an application of logic to oil and gas problems. When we consider, therefore, the relationship between lessor, the sublessor and the sublessee, we too should view the situation in a realistic frame of mind, recognizing the inadequacies of the Code and the statutes with respect to mineral law and mineral leases. We must recognize that any attempt to establish law with respect to oil and gas leases based upon landlord and tenant relationship and the provisions of our Code and Statutes relative to such relationship will lead to absurd consequences and dangerous results. Granted that as a general rule there is that distinct difference between a sublease and an assignment. But I take the position that the only resultant effect of this difference is as to development thereafter. It is my firm belief that many of the so-called problems relative to the legal relationship between

a lessor, a sublessor and sublessee are arising in the minds of the lawyers only by reason of a complete misconception of the law applicable to oil and gas leases. Tiffany lays down the fundamental rule that a sublessee is not in privity of contract with the head landlord since there are no contractual relations between them; and he is not in privity of estate with him since there is no relation of tenancy between them. I have no quarrel with Tiffany on the general principle so ably enunciated by him in his monumental work on real property. This principle has been sustained by jurisprudence in every state in the Union. However, Tiffany has devoted his entire work to a discussion of real property and leases insofar as the leasing of buildings and land for occupancy and cultivation are concerned — in the pure and strict landlord and tenant relationship. He has not attempted to cover oil, gas and mineral leases, and so his statements with respect to privity of contract between landlord and sublessee can have no bearing whatsoever upon the relationship of lessor and sublessee in the oil, gas and mineral lease.

It is unfortunate that as a result of the rule enunciated by Tiffany being firmly established in our law of real property, some of us have been led to think that there is no liability on the part of a sublessee under an oil and gas lease to the original lessor, and that there is neither privity of contract or estate between the two. Furthermore, some of us have been assuming that because of the rule a sublessee under an oil and gas lease is not bound by the covenants of the original lease. This leads to the further assumption that his rights and liabilities are governed by the provisions of the instrument from the sublessor to him. The absurdity of this assumption I will pass upon later. However, as a result of these assumptions, questions have been raised as to the rights of the sublessee vis-a-vis the original contract of lease, with respect to the payment of rentals, payment of royalties, right to release, and liability for breach of express or implied covenants. Again we are faced with the fact that most of the confusion regarding these matters has arisen as a result of the courts, in the early days of the oil industry, construing oil and gas leases and their assignments according to rules applicable to landlord and tenant relationship.

To this must be added the fact that we attorneys, or at least some of us, in these modern times feel we must continue to construe oil and gas leases according to the law relative to the leasing of real estate. It is conceivable and admitted that that

tendency may have been justified in the early days of the industry, when the courts decided cases on analogy and not precedents. It is true that there is some analogy, in form at least, between an oil and gas lease and a lease on real estate. Each is termed a lease; each has a primary term; in each the parties are called "lessor" and "lessee"; and under each type of agreement there are continuing payments over a period of years from the lessee to the lessor.

There the similarity ceases. The differences between the two far outweigh the similarities. A lessee of real estate is concerned with the use and occupancy of the entire premises, whereas the lessee under an oil and gas lease only can use such portions of the premises as are necessary in order to develop the property for oil and gas. In a real estate lease the term is definite; in a mineral lease while the primary term is fixed, the actual term of the lease is indefinite, depending firstly upon whether the lessee desires to continue to pay delay rentals, thereby maintaining the lease in force, and, secondly, upon the contingency and length of production.

In the former the lessee is charged with the obligation of protecting the property from injury, and returning it in the same condition as when received, ordinary wear and tear excepted; whereas in the latter the lessee is expressly given the right to injure the premises and surface in order to exploit the same for oil and gas, and must return only the surface in good condition. In the former he is not permitted to remove or destroy any portion of the property, either above or below the surface; while in the latter it is to the lessor's interest that he remove a portion of the property underlying the surface. Under a real estate lease the lessee pays a fixed rental either each month or at stipulated intervals for the privilege of occupying the leased premises; while the amount of money an oil and gas lessee pays after production is not rent for the use of the property but the lessor's share of the minerals produced, and the money paid prior to production is not rent for the use of the property, but moneys paid to delay drilling operations, in other words, to avoid use. Furthermore, the amount of money paid after production varies from month to month, as production increases or decreases.

The foregoing distinctions between a lease of real estate and an oil and gas lease are present regardless of whether the latter type lease is held to be a conveyance, a servitude, a determinable

fee, or an incorporal hereditament, and regardless of whether the lease covers acreage in Texas, Louisiana, Oklahoma, North Dakota or California.

I have earlier quoted the basic rule laid down by Tiffany to the effect that the sublessee has no privity of contract with the lessor because he has no contractual relations and he is not in privity of estate since there is no relation of tenancy between them. It is well, therefore, to examine and compare the contract to sublease with respect to realty and the so-called "contract of sublease" in common useage in Louisiana in connection with transfers of rights under oil and gas leases.

In the first instance, A has leased a building to B for a term of years at a fixed monthly rental. The contract of lease is signed by both parties and contains all of the usual and customary provisions with respect to the leasing of a piece of real estate. B thereafter desires to sublease a portion of this building to C. In order to accomplish his purpose he prepares a contract of lease to be executed by C and himself, usually embodying in it almost all of the terms and provisions of the lease he has already taken from A. He describes the portion of the building leased, the term of the lease, and the monthly rental for the same. He reserves in this contract all of the liens and privileges granted to a lessor, and usually provides that in the event C defaults in his rent the rental for the balance of the term becomes due and that B can collect in addition, interest and attorney's fees. This contract is as ironclad as the one B had to sign with A. Furthermore, rarely is there any reference in this sublease to the original contract of lease and never does B assign or convey to C any interest in the original lease.

On the other hand, most of the subleases of oil and gas leases are made on the printed "Assignment of Oil, Gas and Mineral Lease Form." This printed form is one page only and in it the transferor conveys to the transferee all of his right, title and interest in and to that certain oil, gas and mineral lease specifically described and referred to. There is usually typed on this printed form, or attached as a rider, some special clause such as a reservation of an override, or an obligation to drill a well, or a limitation as to depth or term, or a right or reassignment under certain conditions or a combination of some of them. Other instruments of sublease of an oil and gas lease are typed, but, for the most part, they contain the same essential provisions as the

printed form, especially the language that the lessee grants and conveys to the sublessee all of his rights, title and interest in and to the lease insofar as it applies to all or a portion thereof.

How similar are these two modes of transfer? The oil and gas sublease is not usually a lengthy contract of sublease embodying specific terms, larger rental payments, and paragraphs containing duties, rights and obligations copied from the original lease. It follows neither in form nor content a sublease of realty. It grants no liens and privileges in favor of the sublessor, no acceleration clauses in the event of default of rental payments, no provisions for attorney's fees and interest in the event of non-payment of rent. On the other hand, it always transfers from the sublessor to the sublessee the sublessor's rights, title and interest in and to the original lease and, in the printed form, it customarily carries the following provision: "The said assignee agrees to faithfully carry out all of the provisions of the original lease insofar as it applies to that portion of tract conveyed."

Of course there is no privity of contract between the subleasee and the landlord in a lease on realty and there is no privity of estate since there is no relation of tenancy between them. The basic difference between these two types of subleases is that in the sublease of an oil and gas lease there is privity of contract between the lessor and the sublessee and there is privity of estate since the sublessee is bound by and must carry out the provisions of the original lease. Therefore, there can be no analogy drawn between the two types of instruments nor can any analogy be drawn with respect to the relationship between the parties to a sublease of realty and a sublease of an oil and gas lease. Such being the case, there should be and can be no analogy drawn between the law with respect to the relationship between a lessor, a sublessor and a sublessee in the two instances. The general rules of landlord and tenant relationship applicable to subleases can have no bearing whatsoever on the relationship between all of the parties to an oil and gas lease and sublease. Any attempt to make these relationships analogous can lead to but absurd consequences.

All the questions arising with respect to the relationship between a lessor, a sublessor and sublessee revolve around the matter of privity of contract between the original lessor and the sublessee. There are no Louisiana cases on the subject, and but few

in other jurisdictions. In Kansas, it has been held that a lessor could sue a transferee who secured production for a production payment, rather than the original lessee, who retained a portion of the property. In California, a lessor sued a sublessee for royalty and was permitted to recover on the theory that the sublessee had assumed the obligations of the lessee. The court recognized that there were no "binding precedents" for its decision, but said that the better rule would be to give the lessor such a right of action. In a later California sublease case the court said:

> "The very nature of the mining industry ordinarily makes it necessary that royalties be paid from production and by the party in possession."

It further said that "an oil lease is different from the usual usufructuary leases in commerce and trade." In Montana the court held that a sublessee could not release a lease without joinder of the original lessee, but here the lessee had reserved a right of re-entry, which otherwise would have been violated. In Oklahoma the court held the transferee, and not the original lessee, liable for salt water damages, saying:

> "Upon the assignment or sublease by the original lessee and the entry into possession and control of the leased premises by the assignee or sublessee, the original lessee stands in a position similar to a lessor, and his duties and responsibilities to third persons are not greater than that of a landlord."

The question we are confronted with in all these instances is whether the sublessee in a sublease, as distinguished from an assignee in an assignment, should be treated as owing the same duties and obligations to the lessor as does the assignee, and as being liable to the lessor in the same manner as the assignee. Whether the distinction between an assignment and a sublease has any significance in this respect has been questioned but not decided. It is submitted, however, that the technical distinction between assignment and sublease should not be considered as significant. The parties to the transfer of an oil and gas lease do not intend to make the difference in form involve practical differences of the sort contemplated under landlord and tenant relationship. The primary motive of the assignment or the sublease is to pass ownership of the rights created by the lease. If the instrument of transfer is a sublease it is because of right of

reversion, retention of override, or the like. It would be most unfortunate if such incidents would cause a destruction of the lessor's right to look to the transferee for the performance of the ordinary duties associated with the lessee under an oil, gas and mineral lease. The transferor in either instance, assignment or sublease, does not expect to, does not intend to, and actually does not exercise or retain any control over the transferee in his administration of the leased premises except, possibly, as to an express obligation set out in the instrument of transfer.

One new case has been reported since commencement of this dissertation. It is Berman v. Brown, reported in the Advance Sheets from March 25, 1954. Two positive statements were made by the court as follows:

> ". . . as Brown was a sublessee . . . and not an assignee . . . no privity of contract existed . . . (between him and plaintiffs)."

And

> "It is firmly established in our jurisprudence that there is no contractual obligation by and between a lessor and a subtenant."

The facts in the case are worth analyzing before considering the effect of these statements. A leased a considerable amount of acreage to B. B assigned the lease to the plaintiffs, Berman et al. Plaintiffs subleased the land to C, reserving an override. C subleased it to D. D assigned to E. E subleased the property to the defendant, Brown. Brown assigned the property to F. When plantiffs subleased the property the overriding royalty clause provided that it should apply to any renewal or new leases made by "assignee" within a year from the expiration of the lease. Brown's transferee was sued for a cancellation of the lease for non-development by the lessor who obtained a favorable judgment. Brown immediately secured from the lessor a new lease, then drilled the land and obtained production. Plaintiffs then sued, seeking to have their override declared effective against production from the new lease. The court held that Brown, being a sublessee of E in the foregoing chain, had no privity of contract with the plaintiffs and, accordingly, was not bound by C's agreement with the plaintiffs, except as to the first lease. Frankly, the number of transfers in between plaintiffs' acquisition and defendant's acquisition gives rise in itself to confusion with respect to the relationship between the various par-

ties. While Brown was a sublessee of E, was he not also a sublessee of plaintiff's, the original sublessor?

The court, in support of the secondly quoted statement, cites the Audubon Hotel and Sun Oil cases, together with Taylor on "Landlord and Tenant." It is submitted that the Audubon Hotel case and the text book do support such statement, it being axiomatic insofar as landlord and tenant relationship is concerned. The Sun case, however, *did not* concern itself with "privity of contract" and that point was not pertinent to the issues involved. The French commentators' comments were, accordingly, purely dicta, as were Taylor's comments. Furthermore, it must be recognized that in this case there was no integral obligation of the lease sought to be enforced between lessor, sublessor and sublessee. A collateral deal, not related to the obligations of the original contract of lease, was the subject of the lawsuit. The original lessor was not involved, nor were any of the direct obligations imposed by the original lessor. Accordingly, the general statements made are not applicable to the conclusion reached. It was not necessary to hold that there is no contractual relationship between a lessor and a subtenant for the reason the case did not involve any controversy between a lessor and subtenant. The holding, therefore, is dicta.

The distinction between an assignment and sublease in the other oil and gas cases was important *only* for the purpose of determining whether operations on the transferred portion would keep the balance of the lease in effect. The question in all those cases was simply one of cancellation of the leases and had nothing whatsoever to do with the legal relationship between the parties. Further, in the Sun case the court did say:

> "Every sublease is in a sense an assignment but every assignment is not a sublease."

In discussing the effects of the difference between a sublease and an assignment, Merrill has stated:

> "Whatever may be the case with respect to the draftsmanship of transfers of real estate leases, very likely no intent is present in the minds of the parties to the transfer of an oil and gas lease to make a variance in form involve practical significance of this sort. *The primary motive is to pass the ownership of the rights created by the lease.* The transfer is for the full amount of the unexpired term in the great majority of cases. If the instrument of transfer resembles the sublease of

real property, this usually is either because of the reservation of a right of reversion upon breach by the transferee, or because of the reservation of a royalty interest or an oil payment. *It would be most unfortunate if such incidents should destroy the lessor's right to look to the transferee for performance of the ordinary duties associated with the lease.* Dare we hope that the courts will not deem themselves bound by the shackles of a differentiation which originated in the needs of an entirely distinct relationship." (Emphasis added).

It is suggested that in the Berman case the statements I have quoted are inapposite, and, therefore, cannot be considered as decisive and controlling for future controversies where there are involved questions between lessors, sublessors and sublessees, concerning the direct obligations of the lease. It is further suggested that the court has followed the interpretations given only landlord and tenant sublease cases where two separate and distinct lease and sublease contracts are involved. It is reiterated that it would be most unfortunate to apply landlord and tenant law to the interpretation of oil and gas leases. The development, progress and prosperity of the oil and gas industry is dependent upon proper interpretation of its basic contract, the oil and gas lease, based upon law applicable to it, and to it alone. Like Merrill, I can only say "Dare I hope that the courts will loose themselves from the shackles of a differentiation based upon an entirely different relationship?"

No discussion of this problem would be complete without referring to a recent Louisiana decision. This is a landlord and tenant case where defendant leased a building to A and gave him a right of renewal as well as an option to purchase. By a series of subleases and other instruments of transfer, plaintiff acquired a sublease on the building and also the option to extend or buy. Thereafter and within the time limit, it exercised the option. Defendant refused to deliver title on the grounds that plaintiff had acquired an interest by sublease and being a sublessee, had no privity of contract with the original lessor and could not exercise the rights granted to the original lessee. The court held that the legal effect of the contract was that the plaintiff became a subtenant of the premises but an assignee of the option to acquire and that defendant had to respect the option granted. The court, in citing the various sublease cases in Louisiana, said that it does not follow that the defendant's position of lack of privity of con-

tract with the plaintiff was well taken. The point is that here, in a landlord and tenant case, the court recognized a privity of contract between the original lessor and the sublessee even though a sublease was involved. The court further recognized that an instrument of transfer could be a sublease in part and an assignment in part. In the language of the court, an "assignment of the lease and a sublease of the premises are permissable." Carrying this reasoning one step further, can we not say that insofar as the oil and gas lease is concerned, it is true that the premises were subleased, but the lease in all other respects was assigned. Such being the case, the conclusions of our courts with respect to the effect of sublease on partial development will still remain in full force and effect. However, the rights of the sublessee with respect to payment of rentals or royalties, liability for damages, and ability to release can be treated as though the lease itself had been acquired by assignment.

I advance this theory purely as an alternative route to reach a proper and sound theory of law that the sublessee of an oil and gas lease is in privity of contract and privity of estate with the original lessor. I say "alternative," for I am firmly convinced that, basically, the law of landlord and tenant has no place in the law of oil and gas. Regardless of which route is followed I believe there is privity of contract and estate between a lessor and sublessee; the sublessee can act in the same manner and to the same end as an original lessor or assignee; that his duties and rights are the same. The courts have consistently recognized the fact that oil and gas leases and leases of realty are entirely dissimilar. The mode of business attendant to real estate and to oil and gas is entirely different. The law with respect to both categories, in construing the rights of lessor and lessee, arrives at different conclusions.

It is submitted to you, therefore, that the courts should recognize these differences in construing oil and gas leases and their transfer, and not feel impelled to follow ancient precedents in landlord and tenant cases, where the latter obviously do not fit the fact situations or their application would work injustice. It is up to us, as attorneys, to use our best efforts before the courts and the legislature to clarify this situation. Oil and gas leases cannot be compared to leases of realty, they are not the least analogous. The law governing them, therefore, should not be based on such an attempted analogy.

Problems Presented in Connection with Paying Delay Rentals on Oil and Gas Leases

Delivered by George Conger at Biloxi, May 4, 1954
Section on Mineral Law

As a basis for a discussion of the topic assigned, a brief review of the historical background of the modern and commonly used type or form of oil, gas and mineral lease may be of some benefit. The petroleum industry is in many phases unique and differs greatly from most ordinary business endeavors. The peculiarities of specific problems inherent in the industry —as in other highly specialized and unique fields — make it necessary that its contracts be particularly adaptable and applicable.

Mineral lease contracts, the very basis for much of the mineral development in this country, and even internationally, are to a considerable extent quite novel and differ greatly from lease contracts in the general commercial field. Yet, in all of the mineral producing states of this nation, and to a lesser extent even in lease contracts or concessions between foreign countries and the oil producing companies, mineral leases generally adhere to the same pattern and contain the same basic provisions as to the rights of the parties; the landowner-lessor and the explorer-developer-lessee.

Specific terms and provisions vary but the type contract usually is the same. This has not come about merely by chance or coincidence. There are sound reasons for this sameness in principle, developed through the years by experimentation, and the innovation from time to time of new provisions to meet new situations.

When the petroleum industry first began to assume an important position in the economy of this nation and the world, beginning shortly after the discovery of the famous Drake Well in 1859, the mineral lease was created and its evolution began. Then, as now, the landowner wanted his land developed for oil and gas production but was incapable of doing it himself. Then, as now, the producer was capable of engineering the promotion but lacked the land. So, the mineral lease was born.

The landowner leased his land to the developer and the developer obligated himself to drill for petroleum and if successful to share a portion of the production with the landowner — to pay him royalty.

The interest of the parties — both parties — was speedy development. The idea of the migratory nature of minerals prevailed and immediate development was considered essential. The cash consideration for the lease was usually nominal; the real consideration was the lessee's obligation for the drilling of a well within a specified time and the consequent anticipated sharing of the production. The time allowed for the drilling was usually quite brief. Chances for finding production were highly speculative. Little capital was usually required. The whole nature and scheme of the infant industry was haphazard, uncoordinated, and with little or no long-range planning. The necessity for reserve was unknown.

By the latter part of the nineteenth century, all of this had changed. The petroleum industry had assumed a more than important, even vital, position in the nation's economy. Careful economic planning, great outlays of capital, the development and supplying of wide and divergent markets changed the entire pattern; the thirty or ninety day drilling obligation on small tracts of land did not fit into the new scheme. So, changes in the lease form came about. Usually the drilling obligation remained in the lease but the time allowed for such drilling was extended considerably; the term of the lease was extended; the firmness of the drilling obligation was softened. The "drill or pay" provision crept into the lease. The lessee was required to drill or to pay a specific sum — often quite substantial — for the right to delay the performance of his drilling obligation for a specific period, or for specific periods upon further substantial payments. The "drill or pay" provision is not to be confused with the "unless" provision — what is now also known as our "delay rental" or "in lieu" rental, which was to come later.

Under the "drill or pay" lease the lessee was not to be relieved of his obligation to drill or pay by merely doing neither, terminating his lease and stepping out of the picture. The courts of Pennsylvania, West Virginia and the early oil producing states rejected such right on principles somewhat akin to our potestative condition. A new clause was added. The lessee who, upon deciding that his lease was valueless or that the property affected thereby was barren of petroleum or had been con-

demned, could be relieved of his obligation to drill or pay by a specific payment for the right to terminate the lease. This payment was often quite nominal and one which, like the cash consideration of $1 as the original lease bonus, was to run afoul our jurisprudence as to inadequacy of consideration when the mineral industry was later to move into Louisiana.

Then came the "unless" provision in the mineral lease, which, in its basic form, is commonly used in what we have come to know as our "commercial" oil, gas and mineral lease forms in Louisiana. In recent years this clause in the lease is frequently different in detail in the numerous printed forms used, and also different as to specific provisions in the many special leases individually drafted by the parties to a specific contract. Fundamentally, however, the lease is executed for a defined term of years. There is a grant by the lessor to the lessee of the right to explore his land for mineral development for that defined term — the primary term — be it three years, or five years, or ten years, or whatever period is agreed upon by the parties. Then, notwithstanding the grant for the specified term of years, in the absence of any specific drilling obligation on the part of the lessee, there is the qualifying provision that the lease is to terminate prior to the expiration of the primary term unless there is earlier drilling or payment of specified sums of money at specified periods. Usually, the provision is something to the effect that:

> "If operations for drilling are not commenced on said land on or before one year from this date, the lease shall then terminate as to both parties unless on or before such anniversary date lessee shall pay or tender to lessor or to the credit of lessor in.................. Bank at .... (which bank and its successors are lessor's agent and shall continue as the depository for all rentals payable hereunder regardless of changes in ownership of said land or the rentals) the sum of .... Dollars ($......), (herein called rental) which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months. In like manner and upon like payments or tenders annually the commencement of drilling operations may be further deferred for successive periods of twelve (12) months each during the primary term. The payment or tender of rental may be made by the check or draft of lessee mailed or delivered to lessor or to said bank on or before such date of payment. If such bank (or any successor bank) should

fail, liquidate or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default for failure to make such payment or tender of rental until thirty (30) days after lessor shall deliver to lessee a proper recordable instrument, naming another bank as agent to receive such payments or tenders. The down cash payment is consideration for this lease according to its terms and shall not be allocated as mere rental for a period. Lessee, or any assignee hereunder, may at any time execute and deliver to lessor, or to the depository above named, or place of record, a release or releases covering any portion or portions of the premises held by him, and thereby surrender this lease as to such portion or portions, and thereafter the rentals payable by him shall be reduced proportionately."

The purpose of this clause is to protect the lessor, whose primary interest usually is to procure the drilling and development of the land, from having his land encumbered by the lease for long periods of time without any drilling, or if the drilling is delayed for such considerable time, to provide to him some monetary consideration to compensate him for such delay. It is also designed to protect the lessee, whose primary interest ordinarily is to explore the land but for good reasons to him may desire a delay in the actual drilling. Furthermore, there is a protection to the lessee in providing a means of terminating the lease in which he is no longer interested through the development of information considered to be unfavorable to the probabilities of production; or, as is more frequently accurate, the failure to develop favorable information.

A valid consideration has been paid for the lease at the outset, either in cash or something else of value. In this "unless" lease the lessee is under no obligation to drill or to pay the rentals. His rights under the lease are restricted or limited to the extent that, if he chooses not to drill and also chooses not to pay the rentals, his leasehold rights terminate. The lease simply expires — and prior to the termination time provided in the primary term.

Now let us turn to the application and the practical effect of the use of the delay rental provision in the "unless" lease in Louisiana, the rules of interpretation applied to it by our courts, and a consideration of some few of the myriad problems faced by lessees who want to pay the delay rentals to retain their leases but who sometimes find themselves in a quandary as to how, to whom, and when to pay such rentals.

Although as early as 1870 the Supreme Court of Louisiana had interpreted an oil, gas and mineral lease which had been executed in 1865, in general form and principle used in the then oil producing common law states (*Escoubas v. Louisiana Petroleum & Coal Oil Company*), our oil and gas jurisprudence actually began to be established only shortly after the turn of the century. With the discovery of the fabulous Spindletop Field near Beaumont, Texas, landowners in southwest Louisiana became highly oil and gas conscious. Mineral explorers and developers came into that section of Louisiana where there had been similar surface indications of the existence of oil and gas as had been found in the Spindletop area. These promoters brought with them the mineral lease contract forms which had been developed and were being used in the common law states where the mineral jurisprudence had by that time become fairly well stabilized. They procured execution by the Louisiana landowners of these mineral leases containing terms and provisions many of which were not in conformity with our legal principles.

Beginning with the 1907 case of *Jennings-Heywood Oil Syndicate v. Houssiere-Latreille Oil Co. et al.*, the Supreme Court assumed its monumental task of developing our mineral jurisprudence. This case interpreted, among other provisions of the mineral lease before it, a delay rental payment clause. During the period from 1907 until the late 1930's, certain very definite rules were established with reference to the time and manner and the parties for the payment of delay rentals provided under the "unless" lease.

Actually, the lease before the court in the Jennings-Heywood Oil Syndicate case was a "drill or pay" lease rather than an "unless" lease. The lease recited $1 cash consideration as a bonus (although $50 was actually paid), then provided that the lessee would drill within a stipulated period, or upon payment of $50 in advance quarterly, drilling could be deferred for three-month periods. Three such payments were made, but the fourth quarterly payment was attempted by the lessee four days late. The lessor refused the payment and claimed the lease was terminated for failure to drill or pay the rental timely. The lease also had a provision that the lessee could be relieved of the lease upon payment of $100. The Supreme Court, on rehearing, determined that the lease was invalid, there being no contract because of the absence of a serious consideration to the lessor and the lessee being free to escape his obligations by paying an in-

consequential sum. Notwithstanding the original invalidity of the lease, the court was of the opinion that, even if the lessee had acquired an option to drill or to retain his rights by the payment of the delay rental by failing to make the fourth quarterly payment within the time fixed for the exercise of the option, he had "forfeited" all rights under the contract.

Through holdings in a series of subsequent cases within the next ten or twenty years, many of which arose from the Homer Field in Claiborne Parish and the Pine Island Field in Caddo Parish, the rule was established that such delay payments must be made on or before the due date as provided in the lease, in default of which the lease was terminated. It is interesting to note that many of the leases acquired by the original promoter of the lease block culminating in the Homer Field had been lost through the inability of the lessee to pay delay rentals under such leases simply because of lack of funds. He did acquire such funds within a week or two after the due date and attempted to pay the rentals at that time. In the meantime, however, the discovery well had come in, various lessors refused the tardy tender, and the court held that the leases had terminated. A fortune was lost.

One case — *Keen v. Logan* (decided in 1920) — seems to be out of harmony with the rule otherwise definitely established. The court did allow the payment eleven days late to retain lessee's rights, on the ground that the particular lease contract did not expressly provide for such payment "in advance." Nevertheless, one Justice dissented on the ground that the ruling in the Jennings-Heywood case was indistinguishable from the facts of that case.

Another important interpretation of the delay rental provision of the ordinary oil and gas lease was rendered by the Supreme Court in *Baird v. Atlas Oil Company* in 1920. The Court decided that, in so far as third persons were concerned, the lessee of record, and he alone, had the right to pay delay rentals in order to retain the lease in effect without drilling. The original lease had been assigned by the lessee to another party but the property covered by the lease was erroneously described. Subsequent to the rental payment date, a third party interested in acquiring a new lease on the property, investigated to determine if the owner of record who had previously attempted to assign the lease had paid the rental, and learned that this party had not paid such rental. The court recognized our

doctrine of record title and held that where one seeks to acquire a mineral lease upon property to which the right had been previously conveyed, he only has to inquire as to the status of the claim of the record owner of any prior lease. He is not affected by some other person's prior unrecorded lease. The holding was that where the record owner of the lease failed to make the payments necessary to keep such lease alive, a lease acquired subsequent to such default and upon the assumption that the prior lease had expired, is good as against the transferee of the record owner whose instrument of transfer or assignment misdescribed the property through error, even though (as was true in that case) that assignee had actually made the necessary and timely payment of the delay rental to his lessor. The subsequent lessee is merely required to ascertain whether the lessee of record had made the necessary payments.

As to the payment of delay rentals, good faith, good intentions, justifiable or understandable error, and lack of actual injury to the lessor, were all of no consequence. Aside from questions of equitable estoppel, the rule was that if the delay rentals were not paid on or before specified dates and paid by the record owner, then whatever the excuse for a tardy payment, or whatever the good intentions and understandable cause for the delay in payment, and notwithstanding the lack of harm or injury to lessor, the lease was terminated.

An example of the rigidity of the application of the rule of termination for failure to pay on or before the specified date is *Andrus et al v. Tidewater Oil Company.* The first annual delay rentals in lieu of drilling were to be paid on or before October 29, 1935. Through error, which can be understood under the circumstances of the case, the owner of the lease, Tidewater Oil Company, considered that the rental payment date was February 12, 1936 and undoubtedly had set up its records on that basis. When October 29, 1935 passed without payment, the lessor on November 16 demanded cancellation. This demand was the first knowledge to Tidewater that the lessor considered the lease terminated. Tidewater intended to make the payment. It could have and would have made such payment prior to October 29, 1935 had it realized that to be the proper date. Tidewater immediately tendered the proper amount of money by wire but the lessor refused to accept it and the court cancelled the lease.

The court held that if the defendant had desired to continue the lease in effect it should have paid the yearly rental in ad-

vance of October 29, 1935, and when it failed to do so, the lease terminated under the express agreement of the parties.

It is true that in the Andrus-Tidewater case rights of minors were involved, and the unfortunate defendant was in a double dilemma: first, seeking to sustain the validity of the lease before the court in the face of the firm rule that the payments must be made on or before the specified date or suffer the consequences of termination; and second, the fidelity of the court in protecting the interest of minors and the requirement of strict adherence to the letter of the court's order authorizing the execution and performance of contracts affecting the rights of minors. The good faith of Tidewater, its willingness, its desire and its ability to pay, brought to it no comfort from the court. For that matter, in the very early Jennings-Heywood case the lessee was willing and able financially to make the rental payment on the prescribed due date and desired and intended to make such payment. His failure to make the payment was understandable for there was no provision for depositing payments in the bank, and in that particular instance the lessee, on the due date and for the next several days, was engaged personally in the field, actually occupied with fighting a well fire. That was no excuse to the court, and the lease was terminated.

By the mid or late 1930's, still another principle had been firmly established by the court with reference to the payment of delay rentals which also was rigid and without concern to any equities in the lessee. In the celebrated case of *LeRosen v. North Central Texas Oil Company* and a subsequent case on almost the identical facts, *Clingman v. Devonian Oil Company,* the court held that under the terms of the ordinary oil and gas lease with reference to the payment of delay rentals, such payments to be effective must be made literally to the *lessor,* and the lessor alone. In both of these cases the property subject to the lease was community property of the landowners and their respective spouses. Mr. LeRosen executed the lease, which in its preamble identified him, A. A. LeRosen, husband of Louise Ledoux LeRosen as "lessor." The usual printed form of the lease (Old Bath's Form 10) so commonly used at that time in North Louisiana and other parts of the state, had the simple provision that if operations for drilling were not commenced on the land on or before one year from the date of the lease, the lease would terminate unless on or before such anniversary date the lessee shall pay or tender to lessor or to the credit of lessor in the specified

bank, the specified sum of money. The rental date was December 21, 1926. The lessee, desiring to extend the term for another year without drilling, made the deposit as provided in the lease, in the proper bank, and in the proper amount, on November 27, 1926. Unfortunately, however, the deposit was made not to the credit of A. A. LeRosen or to A. A. LeRosen, husband of Louise Ledoux LeRosen, but to A. A. LeRosen *and* Louise Ledoux LeRosen. The lessor notified LeRosen of the deposit and the purpose of the deposit and the manner of same. The bank also similarly notified him. Actually, Mr. LeRosen had his office in the same building in which the bank was located, and although knowing for nearly a month of his lessee's payment and the manner in which such payment had been made, made no protest or demand for correct deposit or gave any indication that he did not accede to the manner of the deposit. December 27, 1926 passed and LeRosen demanded cancellation of the lease. The court granted to him such relief, notwithstanding the vigorous dissent on the part of the Chief Justice as to the inequitable result to the lessee.

Within the matter of a few years Devonian Oil Company fell into the same error, under the same circumstances, and suffered the same consequences, receiving only the small comfort of another dissent by the Chief Justice as to the inequities of the result.

As a result of these holdings and the establishment of the jurisprudence that rental payments must be made on time to the proper party, and by the proper party, in penalty of forfeiture of the lease, whatever the reason for the justification for any error and the insufficiency of any excuse for erroneous payment, lessees were confronted with a herculean task in meeting the requirements of the law and their contracts literally, under all of the sometimes hundreds and thousands of leases owned by them. Oil and gas companies, recognizing their precarious position before the courts for any deviation from the straight and narrow path for payment, established elaborate and detailed systems for the payment of rentals and entrusted this responsibility to their trained, diligent and most valued and conscientious employees. Nevertheless, the human element being involved, errors did occur, and however inconsequential or harmless the error, some leases were lost.

Atlantic Refining Company v. Shell Oil Company is a case where payment was made in error because of an erroneous, al-

though reasonable, interpretation of a mineral deed. The lessee lost its lease through failure to pay properly the delay rental. The rental payment date was January 30, 1946, and some months prior to that time the landowner, Furlow, sold to Shell Oil Company one-half of the minerals under his land subject to the lease. An ordinary printed mineral sale form in common use in North Louisiana was used by the parties. This printed form is short and simply provides for the conveyance from the one party to the other of a specified fraction or all of the oil, gas and minerals under the described property. If such property is then under lease, the acquisition is subject to the lease. The conveyance would convey a like interest in the rentals and royalties due under the lease. However, the form contains what, in the opinion of many attorneys, is the entirely superfluous provision expressly stating that the conveyance covers and includes such an interest in "all the oil royalties and gas rentals or royalties due under the terms of said lease, and a like interest in all money rentals that may be hereafter paid in order to keep said lease in effect without drilling."

In North Louisiana many landowners are willing to sell an interest in their minerals but they like to keep what they think of and term "their delay rentals." Many mineral purchasers are willing to purchase undivided interests in the mineral rights and are willing for the landowners to retain "their rentals." Unfortunately, it is not unusual to use the printed lease form and then with pen and ink or typewriter to delete the provision providing "and a like interest in all money rentals that may be hereafter paid in order to keep said lease in effect without drilling."

In the Furlow-Shell sale that is exactly what was done. This lease also had the usual provision that any change of ownership of the lands subject to the lease would not be binding upon the lessee until served with a certified copy of the instrument creating such change. Shell never supplied to Atlantic a copy of its mineral deed and never requested any share of future delay rental payments. In the course of time and before the rental date, the title to the property was examined from an abstract by Atlantic's attorneys. They were confronted with the mineral deed granting unto Shell one-half of the mineral rights under the land and subject to the lease and with the additional provision that there was conveyed "unto Grantee One Half (½) of all of the royalties, and other benefits, accruing under any valid oil, gas or mineral lease or servitude on said property which has

heretofore been filed for record." Thinking, as would many attorneys, and as did three Justices of the Supreme Court, that on the face of the instrument a one-half interest in any future delay rental payments passed with the grant to the vendee, the attorneys for the lessee advised it to pay one-half of the rentals, when paid, to Shell. That was done. When the rental payment due on January 30, 1946 was so paid, Furlow, the landowner, took the position that in his conveyance to Shell he had retained the full rental payment through deletion of the clause expressly conveying same, and since he had received only half of the payment, the lease had been terminated through inadequate payment. The Supreme Court in a 4-3 decision sustained the plaintiff's position and terminated the lease.

Our jurisprudence prior to about 1948 was in general harmony with that of our sister states, although it may be submitted that our courts had gone considerably further than most of the courts of the nation in the strictness to which the lessee was held to comply with the exact requirements for the payment of rentals, with little or no consideration to equitable principles and justifiable error where the intent and the attempt was to pay properly, and where little or no harm or injury in any inadvertent error was suffered by the landowner-lessor. That the jurisprudence of the other states was more considerate of harmless error and good faith mistake is illustrated by two cases from outside of Louisiana, where more equitable principles were recognized and the lessee was deemed not to have lost his lease through such an erroneous payment.

In *Humble Oil & Refining Company v. Harrison* the Supreme Court of Texas, in 1947, refused to terminate a lease where, though erroneously paid, an honest effort and intent to pay was shown by the lessee, and the error was understandable and harmless to the lessor. The depository bank was advised by Humble to credit the lessor's account with a less amount than he was actually entitled to receive and to credit to a mineral purchaser from the lessor an amount greater than it was entitled to receive. It was undisputed that Humble deposited in each instance a total sum which amounted to the delay rentals in full, but their mistake was in misconstruing a mineral deed (just as did Atlantic in the Shell Oil Company case) and erroneously dividing the rentals between the parties. There was no evidence that Humble did not act in good faith nor did the evidence show that Humble acted negligently. The evidence showed affirmatively

that Humble had been willing, if necessary, to make overpayments, as the lessees so often are, in order to insure that the lease is kept alive. The court recognized the general rule that the lessee under "unless" leases loses his lease if he fails to drill or to pay the delay rentals. Yet numerous cases were cited as exceptions to this general rule. Where the lessee has in good faith made a mistaken construction of the lessor's partial conveyance of a mineral interest subject to the lease and has made payment in accordance with such misconstruction, there is a duty on the part of the lessor to notify the lessee of its error and to give it an opportunity to make a proper payment; all this on the theory of estoppel — the theory which was rejected by the Louisiana courts in the LeRosen case and in other cases where the lessor remained silent.

Gloyd v. Midwest Refining Co. is a federal court case which typifies the holdings of courts outside of Louisiana, where equitable consideration and the protection of a good faith attempt to pay delay rentals is in sharp contrast with the harsh Louisiana rule of the LeRosen case and similar Louisiana cases. There a mineral purchaser of an interest already under lease notified the lessee, Midwest Refining Company, of his purchase and asked that his share of the rentals be mailed to him direct at his given address rather than being deposited in the bank named in the lease. The rental date was June 4, 1928. However, the check was lost in the mail and never delivered. When Gloyd notified the Midwest that he had not received the check, that lessee promptly transmitted to him a duplicate check covering the rental, but which was refused on the ground that the payment was too late. The check was tendered to Gloyd a second time and again refused, with the insistence that the lease was terminated. The following quotation from the opinion summarizes the equitable considerations applied by the court:

> "When the lessee in an 'unless' lease in good faith manifests his intention to continue the lease by undertaking to pay such rental through a method and means customarily used in such transactions, in ample time for the payment to reach the lessor or the agreed depository on or before the due date, but due to accident or mistake such payment fails to reach the lessor in time, the lease is not, because of such failure, automatically terminated. This is true because the acts of the lessee manifest an intention not to terminate the lease . . . Equity will only give its aid to the enforcement of a forfeiture where to do so is more cognizant

> with the principles of right, justice, and morality than to withhold it . . . Under the facts in the instant case, it is more cognizable with the principles of equity to withhold than to grant such relief."

Prior to 1948 there were in Louisiana several instances where the Supreme Court in clear cases of equitable estoppel had also refused to forfeit or terminate a lease because of erroneous rental payment. In the 1918 case of *Dellinger v. Smith,* a quarterly rental payment due December 10, 1912 was not promptly paid in advance. Nevertheless, the lessor was held to have been estopped from seeking cancellation for she or her husband, prior to his death, had accepted subsequent rental payments and had permitted the defendant lessee the following year to expend several thousand dollars in drilling a well on the property and in accepting royalty payments for production from that well. The court held that the acts of the lessor in accepting payments for rent, in failing to speak when he should have spoken in order to save the defendant from useless expenditure of large sums of money for drilling of the well, and his acceptance of the royalty for production from the well, had the effect of lulling the defendant into the belief that his dereliction in punctually carrying out the provisions of the lease had been condoned and she was therefore equitably estopped from attacking the validity of the lease. The court stated that "persons bound by reciprocal obligations cannot thus play fast and loose at their option."

In 1941 the Supreme Court refused to cancel a lease in *Risinger v. Arkansas Louisiana Gas Company,* even though the lessee had deposited the delay rental in a Monroe bank instead of the Bank of Ruston as required by the provisions of the lease. The evidence showed that this lessor knew that the lessee company later started the drilling of a well which would require a large expenditure of its funds. Although she had not personally received her prorata share of the delay rentals, she did not notify them that if she did not receive her rentals she would cancel the lease. She was estopped to claim that the lease was not in force at the time the well was drilled and completed, as she stood by and permitted the defendant to spend $62,500 to explore and develop the property.

In 1948 the Supreme Court of Louisiana decided *Jones v. Southern Natural Gas Company,* which might be considered as a landmark case changing the trend of our jurisprudence on this subject. At least the decision tends to yield from the harsh and rigid rule requiring strict compliance with the delay rental pro-

visions to an approach more equitable, giving consideration to the good faith and intent of the lessee, whether or not the lessee's error was one of consequence or inconsequential, and whether or not harm or injury or inconvenience resulted to the lessor through the error. Mrs. Jones leased to an individual a tract of land described by governmental subdivision references and recited to be 518.82 acres, more or less, with a usual delay rental clause stipulating annual in lieu rentals of $518.82. The lease contained the usual clause providing the right for the lessee to assign in whole or in part his interest under the lease. The original lessee did assign the lease as to certain described property, thought to contain 300 acres and which would have contained 300 acres if the governmental sections covered by portions of the property had all been even sections of 640 acres each. The first anniversary date of the lease was September 8, 1944, and on August 24, 1944 Southern Natural Gas Company deposited its check in the amount of $300 to the credit of the lessor in the proper bank and so notified the lessor. Nothing was heard from the lessor in the way of objection or statement that the payment was inadequate. On August 11, 1945 Southern deposited its check for $300 for payment of the rentals due on or before September 8, 1945, in the same manner and with the same intent, to the credit of the lessor, who again refrained from objecting or notifying the lessee in any manner as to the impropriety or inadequacy of the rental payment. On September 10, 1945, two days after the second anniversary date of the lease, the lessor demanded a release on the ground of improper and inadequate rental payments for the reason that the lands included within the assignment to Southern actually totaled 322.629 acres and, therefore, the rental payment was inadequate by a shortage of $22.63. There was some dispute as to just how much more than 300 acres were in the tract included within the assignment, but it was conceded that there was an excess of somewhere between one or two acres and 22.629 acres.

The district court cancelled the lease for inadequate rental payments in the absence of drilling. Whether equitable or not, one can hardly quarrel with the district court's holding, in view of the Supreme Court's decisions in the LeRosen case and the Clingman case, for these was no basis for distinction of the cases. It is believed that most attorneys in the oil and gas industry would have advised Southern Natural Gas Company that it had lost its lease.

The Supreme Court, however, did take into consideration the equities as applicable to the parties, the lessor on the one hand and the lessee on the other, and held that the lessor was estopped from demanding the forfeiture of the lease for nonpayment of the full delay rentals. She knew that the party making the payment believed that the amount was sufficient and had good reason to believe that it was sufficient. She gave the defendant no opportunity to correct its mistake. The court stated that there was ample authority for the proposition that considerations of equity may prevent a forfeiture of a mineral lease where the failure of the lessee to pay the full amount of the delay rentals, or his failure to pay it within the time stipulated, is the result of a mistake on his part, and where the circumstances are such that the mistake is a pardonable one. Equity required that when the lessor learned of the mistake she should promptly inform the lessee and give the latter an opportunity to correct it before she, the lessor, can demand a forfeiture for nonpayment of the rental within the time stipulated. The court cited, among other cases from outside of Louisiana, Gloyd v. Midwest Refining Company (*supra*) and closed its opinion with the positive statement that, in so far as this case was not consistent with LeRosen v. North Central Texas Oil Company (which obviously it was not), then the former henceforth must be considered overruled.

In the 1953 decision of *Baker v. Potter* the Supreme Court again and further relinquished its previously adopted rigid rule of strict compliance with the lease provision for the payment of delay rentals. The delay rental date was September 15, 1950. The depository bank was the Springhill Bank & Trust Company of Springhill, Louisiana. At 8:30 a. m., September 15, 1950, the lessee or his sublessee wired, by Western Union Telegraph Company, the rental payment in the proper amount and to the proper bank. The money was received by the Western Union office at Springhill about the middle of the morning, but although the telegraph company's representative notified the bank that the money had arrived, refused to deliver to or deposit the money in the bank because of some company rule which had not been complied with in that instant case. It was after banking hours when the telegraph operator had satisfied herself as to compliance with its company rule. The money did not reach the bank until the next day, Saturday, September 16, and was not credited to the lessor's account until the following Monday, September 18. Thus, the money was actually not available to the lessor until

three days after the due date and there was no expressed authority in the lease for the lessee to adopt the method of transmitting his delay rental by telegraph. The pertinent provision of the lease was as follows:

> "The payment or tender of rental may be made by check or draft of lessee mailed or delivered to lessor or to said bank on or before such date of payment."

The lessee followed neither of the alternative provisions for delivery of its rental payment. Nevertheless, the Supreme Court refused to cancel the lease (although the district court had done so), holding, since the lessee could have placed its check or draft in the mails on September 15 and averted a forfeiture, the use of any other reliable agency such as a telegraph company for the delivery was permissible under the contract. The court stated that when the parties designated the mails as the transmitting agency it did not exclude the use of another agency of equal reliability, for the important factor for which the parties were providing was the timely placing of the funds into safe hands for delivery in the ordinary course of events, and not the particular mode of transmission.

If a guess may be permitted, it is submitted that prior to this decision many lawyers experienced in the interpretation of oil, gas and mineral leases would have unhesitatingly advised that, on the aforementioned facts and the law then existing, the subject lease had been lost through failure to make a timely and proper delay rental payment. However, the decision is a satisfactory one in that it is a further recognition, which for years had been refused, that a reasonable good faith act and evidence of intent to pay properly the delay rentals through a desire to retain its lease, should not be fatal to the lessee if the literal requirements of the lease are not strictly followed. Certainly in such cases as this, where no harm was done, the lessee should not be subjected to the severe penalty of loss of his lease.

There seems to be a definite turn in the trend of the attitude of our courts on the subject, but there can be no lessening in vigilance and caution on the part of lessees in determining the time and manner in which delay rental payments should be made. There are numerous questions which have arisen and which have caused considerable concern to lessees and their legal advisers as to rental payment problems — questions which have not yet been judicially determined. In recent years there has been an

increased variance in the lease forms in use throughout the state. Certain forms are in common use in the northern part of the state and certain other forms are more prevalent in South Louisiana. These leases vary as to the specific provision with reference to delay rentals, and attorneys for lesssees must resort to a careful consideration of the particular lease form in an instant case in advising their lessee clients on this difficult problem.

Some attorneys have expressed concern as to the proper party to make a delay rental payment in instances of the sublease. The Supreme Court, beginning with *Smith v. Sun Oil Company* and continuing through a series of holdings, the latest of which is *Berman v. Brown* (decided in January, 1954) has well established the distinction between a sublease and an assignment of an oil, gas and mineral lease. Where the owner of a lease conveys to another party all the rights thereunder, or all the rights under a specific portion of the property covered by the lease, save and except a specified overriding royalty interest therein which is expressly reserved unto the person conveying the lease, the contract is a sublease and not an assignment. Since it is a sublease, the grantor under this contract is yet the owner of the lease. The Supreme Court has determined that only the owner of the lease or someone acting on his behalf has the right to pay delay rentals.

This method of conveying an interest in the lease is so common in the state, the question is posed: Is the sublessee entitled to pay the delay rentals when he is not the owner of the lease? Actually, this practice is commonly followed by many operators in the handling of leases under whench they are merely sublessees. In Baker v. Potter (supra) the parties there making the delay rental payment were actually sublessees, for they had acquired their lease from the original lessee who retained for himself a 1/32 overriding royalty interest. Throughout the opinion the parties who were seeking to sustain the propriety of their rental payment were referred to as sublessees and no question was raised in the opinion of their right to make such rental payments. Apparently such issue had not been raised in the pleadings or briefs. It is submitted that a sublessee has such an interest in the lease as to entitle him to make the rental payment, for the purpose and intent of the rule that only the owner is entitled to make the payment is to allow third parties to deal on what the public record shows as to ownership. In the case of the sublessee, surely he has the sufficient record interest and the

privity of contract as to allow him to protect his valuable right through payment of rentals. Perhaps it would be advisable to make such delay rental payments in the name of or on behalf of both the sublessor and the sublessee.

The present doubt existing in our jurisprudence as to the legal status of the reversionary interest in mineral rights and the right of the landowner to trade with reference to such reversionary interest has created a problem with reference to payment of delay rentals in a number of instances. It has become fairly common practice in acquiring leases from a landowner who has previously sold, for instance, a ½ mineral interest, to have the lease specifically provide that it is intended by the parties to cover the lessor's ½ interest and shall further cover any rights, titles and interest in the described lands, *including reversionary mineral rights,* thereafter acquired or inuring to lessor and lessor's successors and assigns. When the outstanding ½ mineral interest is lost through the running of prescription, if the lease had not restricted the description to a ½ interest of the lessor, the doctrine of after acquired title would appear to be applicable. The ½ mineral interest reverting to the lessor, who is still the landowner, is subject to the lease. If, however, the description specifically restricted the interest included as a ½ interest and prescription would later run as against the outstanding ½ interest and the court would hold that this attempt to bring such reverted interest under the lease upon the happening of the event was a nullity, then there would be outstanding and not subject to the lease that reverted ½ interest.

A, the landowner, owns but a ½ interest yet leases his land without any restriction whatever as to the interest therein covered and there is the specific provision that any additional interest, including reversionary mineral rights inuring to lessor, shall be subject to the lease. Reduced rentals are paid under the reduction clause in the lease on or before the rental date, which we may assume is May 1. On May 2 the outstanding ½ interest is terminated through the running of prescription. *Query*: Does the lease cover the full mineral interest, or one-half?

One major oil company recently was confronted with this problem. The lessor was known to own only a ½ interest in the tract covered by the lease. The lease recited to cover and affect "all my undivided interest" in and to the described property. The lease contained the usual reduction clause for an interest

less than the whole, and when the rentals were paid they were paid on such reduced basis; that is, one-half. The lessor, who was an attorney from another state, took the position that the rentals were improperly paid in that only one-half of what he was entitled to receive was paid. When his attention was called to the reduction clause, his answer was that the contract must be read and treated as a whole and the use of the phrase "all my undivided interest" was a restriction and limitation on the reduction clause, for it was known and indicated that he only owned a one-half interest. There is a Texas case — *Texas Company v. Parks* — holding to such effect. In this instance, however, the contract was on the form known as "Form 42 CPM-New South Louisiana Revised Four (4)—Pooling" which, in the reduction clause, specifically provides that "if the lessor owns less than the entire undivided interest (whether such interest is herein specified or not) rentals and royalties as to the land in which an interest is outstanding in others shall be reduced proportionately." Under this plain wording it would seem that even if the lessor's interest had been described as his undivided one-half interest, still the rental could properly be reduced to one-half that provided in the lease. Nevertheless, as clear as this seems, this Florida attorney referred the matter to a very able law firm in Shreveport, which agreed with him, or at least told the oil company's attorney that they agreed with him. It will be interesting to see the outcome.

Recently the question was submitted to a certain law firm as to the right to retain a lease in effect through the payment of delay rentals after the completion of a producing gas well in an area where there was then no market outlet. The printed lease form provided for a shut-in gas royalty payment of $200 for each year for each well producing gas only. The $200 payment had been inked out and in its place there had been inserted the sum of $800. A producing gas well was completed but with no immediate possibility of a market outlet. The lessor sought advice from his attorney as to whether he could resume the delay rental payment, which was approximately $100 per year, rather than to pay the excessive shut-in gas royalty under the lease provision. It would seem that such was not the intent of the parties and that the proper payment would be the shut-in gas royalty rather than the continued delay rental payment. The delay rental payment is an optional right on the part of the lessee to extend his lease without drilling, and this lease, as do

most leases, had the specific provision applicable to the resumption of delay rental payments after drilling within the primary term, but where such drilling resulted in a dry hole or in production which later ceased. It would be a strained interpretation of the contract to apply the delay rental clause rather than the shut-in royalty clause.

A problem arises in instances where a lease is executed by the husband and covering community property. After the execution of the lease and well within the primary term, the husband dies, and the lessee is furnished with a certified copy of the succession judgment placing the widow in possession of her community one-half, with the usufruct of the remaining one-half, and the children and heirs of the deceased placed in possession of their one-half subject to the usufruct of the widow. To whom are the rentals to be paid — all to the widow as owner of the one-half and as owner of the usufruct of the other one-half, or one-half to the widow and one-half to the children? In many cases, an agreement in the form of a rental division order can be procured from the widow and the children directing a satisfactory manner of payment. Where such division order cannot be procured, the lessee is placed in the dilemma of determining whether the widow's usufruct includes the right to receive delay rentals thereunder. It is suggested that she would be entitled to reecive all the delay rentals and that the problem arising, and which is still unsettled as to the right to receive royalties, is not present.

Most lease forms have a provision that the lessee may execute and record a release of the lease as to a part of the property covered thereby and be relieved of payment of delay rentals on that portion of the lease surrendered; that is, that the rental payments may be reduced proportionately. Suppose a lease covers a large area in South Louisiana, described by irregular sections or by known boundaries of adjoining land, but agreed to cover a specified number of acres. The lessee releases a portion of the acreage in the lease through an instrument describing certain land out of the original tract and then is confronted with the problem of how much the delay rental should be reduced to retain the remaining acreage under the lease. To be accurate, it would sometimes require a formal survey of the property. To be safe without such a survey, ample margin should be allowed in determining the acreage retained for a serious risk is run and a possible underpayment may be of such extent and under such

circumstances that the Supreme Court's decision in Jones v. Southern Natural Gas Company (supra) would not protect the lessee.

Quite often the land sought to be leased is owned in indivision by several different persons. If all of these undivided owners execute one and the same lease, no problem arises because under the very terms of the usual lease the lessee may deposit the full delay rental covering the entire interest to the joint account of all of these lessors, whatever their proportionate ownership might be. Frequently, however, these undivided owners do not execute the same instrument of lease but execute their own separate lease contracts. If there is doubt, as often there is, as to the correct fractional interest owned by the respective lessors, a serious problem confronts the lessee in determining just how much of the full rental payment should be paid to the respective lessors. An erroneous or under payment would usually be fatal. In a Texas case, *Perkins v. Magnolia Petroleum Company*, the Texas Court of Civil Appeals approved the action of the lessee in depositing the entire amount of the rental payment to the joint credit of all of the lessors, even though they had not all joined in the execution of a single lease. The leases executed by these lessors were identical and named the same depository bank. The court, in sustaining the propriety of the rental payment, seemed to place considerable effect upon the right of the lessee to resort to the interpleader statute of that state, and the procedure followed by the lessee, Magnolia Petroleum Company, was considered to be comparable to resorting to such statute. It is quite doubtful if our concursus statute is available to a lessee in our state who is in such a quandary as to the proper party to receive delay rentals in such a situation.

It is not unusual in the acquisition of mineral leases for errors to appear in the lease acquired. Frequently the property is misdescribed, the parties are improperly identified, or other errors of like nature occur. When such errors are discovered, usually a correction or superseding lease is acquired. In such instances it is important that the parties clearly understand what is to be considered as the correct rental payment date; that is, the anniversary date of the first and original lease or the anniversary date of the correction lease. In *Humble Oil & Refining Company v. Mullican* the lease was executed by Mullican individually and as Independent Executor on January 27, 1944. Some doubt arose as to the proper identification of Mullican's

representative capacity. Purely as a matter of precaution, another lease was acquired, identical with the first, except that it described the lessor as "Mullican, Individually and as Community Administrator." The second lease was dated March 18, 1944 and there was added a typewritten rider providing, "this lease is in lieu and correction of a prior lease dated January 27, 1944 . . . which lease was erroneous," etc. Humble tendered the first annual delay rental payment after January 27, 1945, but well before March 18, 1945. The Supreme Court of Texas held that the rentals had not been timely paid and terminated the lease, over the vigorous dissent of three Justices.

The problems are becoming more numerous and more acute because of the increased value and amount of the delay rental and the inclusion under single leases of quite large tracts, particularly in South Louisiana. For many years attorneys dealing with mineral leases in North Louisiana were not so much concerned with many of these same problems that exist today. The problems existed, and were recognized, but the usual solution was, first, to procure a division order; and second, if a division order could not be secured and enough doubt existed as to the proper party to receive the rentals or the proper amount of the rentals, to advise the client to pay double if necessary. This was reasonably cheap insurance in most instances, for the tracts were small and the delay rental payment of one dollar per acre did not usually run into substantial sums. The lessee was usually quite willing to pay an excess or double rental which was of little cost to him and preserved his rights without question. It is not so simple, however, when dealing with large tracts and where the rental payments are not one dollar an acre, but five dollars an acre, or ten dollars an acre, or even more, and the financial burden of double or excessive payments is prohibitive.

A practical solution to many of the problems is suggested by a relatively new lease form known as "Bath's Form 549-R-1." For many years many of the forms favorably accepted and in general use have had a provision to the effect that if for any reason the lessor considers that operations under the lease are not being conducted in compliance with the requirements of the lease, the lessor shall notify lessee, in writing, of the facts relied upon as constituting a breach thereof, and the lessee shall have sixty, or in some instances ninety or more days after receipt of such notice, to comply with the obligations imposed by virtue of the lease. In other words, if the lessor felt that the lessee was

not complying with the terms of the lease, then it was only reasonable that the lessee be notified of the lessor's complaint and be given a reasonable time to satisfy the lessor or to protect his investment.

The difficulties in correctly interpreting the rental payment provisions of a lease are frequently more intricate than determining whether or not a person has complied with his drilling and production obligation. In many cases the lessee may have no knowledge that there is any doubt as to the sufficiency or propriety of his rental payment. There is oftentimes much more reason where the lessee desires to comply with the rental payment and is capable of complying, and in good faith has attempted to comply, that if there should be error he be given a chance to rectify the error without loss of his lease without warning or notice, than in instances of doubt as to compliance with development requirements. This lease form mentioned has such a provision which seems equitable and should protect the interest of the parties where there is no protection now. The provision is as follows:

> "If lessee shall, on or before any rental due date, make a bona fide attempt to pay or deposit rental, and such payment or deposit shall be erroneous in any regard (whether deposited in the wrong depository, to the credit of the wrong person or persons, in an incorrect amount, or otherwise) Lessee shall be unconditionally obligated to pay to Lessor the rental properly payable for such period, but this lease shall be maintained in the same manner as if such erroneous rental payment or deposit had been properly made, provided that the erroneous payment or deposit be corrected within forty-five (45) days after receipt by Lessee of written notice from Lessor that Lessor has not received his proper rental."

Also, this same form resolves the question as to the propriety of the sublessee making the delay rental payment, by specifically so providing.

In conclusion, it is submitted that, with the present and more realistic approach by the Supreme Court to the problem of the payment of delay rentals, and through the efforts of the contracting parties in mineral leases to provide more specifically as to the rights to rectify errors in such payment, a sound and stabilizing result will be helpful in the industry.

Some Aspects of Percentage Depletion

By Charles R. Bell of Houston, Tex.

Delivered at Biloxi, Miss., May 4, 1954,
Section on Mineral Law

Progress or decline of a nation is not the result of the inevitable. They are both products of the way the citizens of a nation direct the forces that control its social and material welfare. The forces of freedom and education are of utmost importance, but economic progress is also dependent upon the forces of energy and machines to multiply man's productive efforts. The Babylonian, the Greek, and the Roman empires declined and fell unto dust through failure to properly direct the social and material forces which once made them great. The same failures have contributed in no small measure to the decline in the living standards and world position of the peoples of nations which only forty years ago were of the proudest and mightiest in the world. Today the living standards of the peoples of the Far and Middle East are not much different than they were before the birth of Christ, because they have not made use of the abundant material and mineral forces which lie within their reach.

Throughout the centuries man has struggled to raise his standard of living above a subsistence level. Progress in that struggle has been faster and greater in the United States during the past fifty years than in all the rest of recorded time.

How did it happen that we have progressed so rapidly and enjoy so much in this country? A large land area under a decentralized government has undoubtedly been a factor, but this condition exists in other countries, such as backward China. The frontier was important, but our progress has been more rapid since its passing shortly after the turn of the present century. Natural resources have played a major role, but other lands more abundant in natural resources have not progressed as we have. If these things do not explain our success, what are the prime factors which account for our progress and which are indispensable to our future?

Without freedom and education and their underlying spiritual philosophy, the powerful force of individual initiative could

not exist. But this force is not enough. For economic progress, we must have energy and machines.

Productive machines are not run by human energy. They would stand idle but for mineral energy available in great quantities at low cost. We in the United States use an enormous amount of energy to do our work. We use ten times more mechanical energy per capita than do the people of the rest of the world. The energy we use is the equivalent of fifty servants working for each of us. It would take two hundred servants to do the work for the average family of four which machines do in all phases of economic activity. Machines and energy not only do more for us than servants could, but also perform their work at a cost within the means of most of our people.

Our great advantage in energy over the rest of the world is the result of the remarkable development and production of oil and gas.

During the past thirty or thirty-five years the vast increase in energy consumed in this country has been supplied by oil and gas. In fact, about 60 per cent of the mineral energy now used in the United States comes from these resources.

The remarkable increase in our supplies of oil and gas came about because we live in a political climate that encourages and rewards individual initiative and enterprise. Man does not invest in a business enterprise unless he believes that the opportunity for financial reward is commensurate with his financial risks.

In all industries, the expenditure of capital for a factory, a warehouse, or machine tools can be counted upon to result in specific tangible facilities capable of producing income. The cost and capacity of such facilities is known in advance of their purchase, and operating costs and useful life can be reasonably estimated. With this advance knowledge, the risks are not whether the investment will result in a productive facility, but rather what it will earn in light of competition, demand, price, and other economic factors. Producers of petroleum are faced with the same risks after they have discovered and developed an oil or gas field; but in addition they face a unique problem, because they never know in advance what capital values will result from the money they risk in the search for and development of oil fields.

Those who explore for and develop petroleum reserves know well that a large proportion of the money they risk will not result in a productive, salable asset. The money spent for exploration and dry holes must be recouped from profitable discoveries. In addition, oil producers must make a fair profit if they are to have the incentive to risk and re-risk their money to find and develop new reserves.

Great financial risks are involved in the search for and the development and operation of oil and gas properties. Oil and gas are exhaustible natural resources. The quantity of oil or gas in a given natural reservoir is limited, and the amount which may be extracted depends not only upon the size of the structure but more so upon the thickness and other physical characteristics of the productive formation. Many structures contain no oil, and many others do not contain enough oil to be produced in commercial quantities. The presence of oil and the condition of the productive formations cannot be determined except by costly drilling.

It is axiomatic that producers of oil and gas, in order to remain in the business, must be constantly searching for new discoveries. This is done by highly trained geologists and geophysicists who engage in continuous search for areas which offer possibilities for oil or gas production. In addition to the exploratory costs, the operator must obtain leases and pay delay rentals on as much land as his resources and scope of operations permit. The operator knows from experience that his exploratory crews may work months without locating a structure thought to have possibilities of production. He knows, too, that subsequent and more extensive exploration will, in many instances, indicate the desirability of abandoning the area without drilling. In other areas test wells (wildcats) will be drilled. On the average, only one out of nine wildcats drilled in the search for new fields will find any oil. Only one out of 44 wildcats finds a field capable of producing as much oil as is needed to supply our needs for about four hours. Only one out of 991 discovers a major field.

Even after a productive area is discovered, the hazards still remain with respect to its development. Sound conservation practices dictate that additional wells must be drilled to define the limits of the productive area. Some of these wells will be dry, and others will be incapable of producing enough oil to repay their costs. In fact, one-fourth of all productive wells drilled never return the cost of drilling.

No other industry, including mining, is faced with financial risks equal to those which face the producers of petroleum. In the case of coal, very large deposits have long been known to exist, so very little, if any, exploratory expense is required; and the money spent to develop the deposit can be counted on to result in a producing facility. In the case of other minerals whose location is not known, it is customary to explore the surface for outcroppings and to drill core hole tests at relatively modest cost before large sums are risked to develop production.

Long ago Congress recognized the unique character of the petroleum industry and the need to establish an economic climate and stimulus which would encourage investors to undertake the tremendous financial risks inherent in finding and developing the nation's petroleum reserves. Congress believed that the problem could be solved by the adoption of a principle of income taxation that would assure the natural resource industries that the capital value of their discoveries would not be taxed as income. Accordingly, in 1918 a depletion provision known as "discovery value" depletion was adopted. Under this provision, producers were allowed to deduct the unit value, determined as of the date of discovery, from the selling price of the oil as and when produced and sold. The remainder of the selling price after deducting other costs and expenses was taxed as ordinary income.

The percentage depletion provision was first adopted in 1926. Under this provision the method of calculating depletion deductions was changed, but the principle of tax-free recovery of capital value was not changed. Percentage depletion was substituted for "discovery value" depletion, because of the extreme difficulty of determining a "discovery" value that could be agreed on by taxpayers and the Treasury Department. The maximum rate of 27½ per cent of the gross value of oil and gas at the time produced was not arbitrarily determined. Statistics developed by the Bureau of Internal Revenue from eight years' (1918-1925, inclusive) experience with discovery value depletion showed that discovery value represented about 30 per cent of the market value of oil at the time produced. It was also observed that this relation of discovery value to the market value of produced oil was roughly uniform, notwithstanding fluctuations in price. The 27½ per cent rate was the result of a compromise between the Senate and the House. The former recommended a 30 per cent rate and the latter 25 per cent.

A very strong incentive to risk great amounts of money in oil search and development was what Congress, in the national interest, sought and did create and has since maintained through the depletion provisions.

There are certain writers, radiocasters, politicians, and others who would mislead the public with statements containing half-truths and misconceptions about percentage depletion. Unless these statements are carefully analyzed, those unfamiliar with the oil business may easily and readily conclude that the statements contain the entire truth. Unfortunately, the authors of these statements are deliberately and maliciously attempting to prejudice the American public against the oil industry. These authors have in recent years pointed to certain provisions of the Internal Revenue Code which they label as "loopholes" — one being percentage depletion.

Now the truth is that our income tax laws contain many "special provisions." Every individual or corporation — in fact, every taxpayer — receives some benefit from one or more of these "special provisions." Yet all of the "special provisions," except those selected as good political targets, have been completely ignored by the "loophole" critics.

Fundamentally, the elements that enter into the computation of taxable income are uniformly applied, but Congress, through the years, has wisely made "special provisions" which are applicable to the type or nature of the business for which they were designed and not to any others. Congress has created such provisions because it recognized the wide differences in the degree of financial risk and in the type and nature of business undertakings. These "special provisions" are usually in the form of exemptions, exclusions, deductions and credits. "Special provisions" are applicable to banks, to insurance companies, to regulated investment companies, to utilities, to mines — and to oil and gas operators. "Special provisions" exempt charitable, religious, and educational organizations from tax; "special provisions" are applicable to cooperatives. Labor unions are exempt from taxation of certain income because of "special provisions."

Further, certain "special provisions" apply to individuals. Every individual is allowed an exemption of $600 by "special provision"; individuals over 65 or blind are allowed an additional exemption of $600 by "special provision." The splitting of

income between husband and wife is permitted by "special provision." The standard deduction is another example of "special provision," and under it many people are allowed a deduction in excess of what was actually spent. Also by "special provision" you may make a gift to your dear old alma mater, call it a contribution, and deduct it from your income when calculating your tax liability. Do you hear the "loophole" critics railing at these "special provisions"? I need not suggest why they don't.

These "special provisions" are only a few; the Internal Revenue Code contains many more. Back of all of them, there is reason, purpose, and soundness. Our robust, healthy economy reflects the wisdom of the Congress in providing for the variances in the needs, the risks, and the purposes of business undertakings.

The term "loophole" denotes a flaw which was not intended and which all taxpayers do not detect, thus making it possible for the crafty to circumvent the intent of Congress to their exclusive advantage. The "loophole" critics would have us believe that the "special provisions" at which they rant are flaws in our laws of taxation. Nothing could be further from the truth!

There are sincere people who suggest that the adverse effect of a reduction of the percentage depletion rate could be offset by price increases. Nothing that I could say in rebuttal would carry the force of what the President's Materials Policy Commission (known as the "Paley Commission") said in its report to President Truman in 1952. That Committee said:

> "Because of the past erratic price behavior of minerals and the long intervals between initial investment and yield from production, the Commission concludes that incentives provided through the price structure are unlikely to bring about enough exploration and development to meet national needs for domestic production of scarce minerals."

There may be some who feel that the industry's capacity to produce oil is more than adequate, so why all the emphasis on the necessity to continue the exploration effort at an ever-increasing rate? The truth is that we do have the capacity to produce more domestic crude than is now being used. Since World War II the oil industry, by spending prodigious sums of money, developed a productive capacity of about 1.5 million barrels a day in excess of consumption of domestic crude. This is not enough to cope with the emergencies which may develop out of the international turmoil that exists today. James Forrestal,

the late Secretary of Defense, said about five years ago:

> "The maximum military requirements of petroleum, in the event of a war emergency, are now estimated nearly double the requirements of World War II . . . in other words, instead of 1,375,000 barrels a day, it would be about 2,750,000, which would be roughly 70 per cent of our daily production before we entered World War II."

In case of another great war, much of the foreign oil will be denied us and diverted to the enemy. In addition, we may well have to supply oil to those of our allies whose normal sources of supply have been cut off. Therefore, it is of paramount importance to us as a nation that the oil industry continue to increase its exploration efforts in this country and in Canada. Within their bounds lie the only sure sources of supply in the event of emergency.

We are faced with another situation which should sober our thinking. In 1946, our country had larger known reserves of oil than any other area of the world, but we were consuming it more rapidly than any other area. In that year we possessed 35.5 per cent of the world's known reserves, and in that year we produced 64 per cent of the world's consumption.

(MILLIONS OF BARRELS)

	Estimated Crude Oil Reserves 1-1-46	Production 1946	Per Cent of World's Reserves	Per Cent of World's Production
United States	20,900	1,851	35.5%	64.0%
Middle East	18,500	252	31.4	8.7
Venezuela	7,000	388	11.9	13.4
All Other	12,500	403	21.2	13.9
Total for World	58,900	2,894	100.0%	100.0%

By the end of 1952, the world's oil supply situation had undergone a drastic change. At the beginning of 1953, we possessed 21.2 per cent of the world's known oil reserves; and in that year we produced about half of the world's consumption.

(MILLIONS OF BARRELS)

	Estimated Crude Oil Reserves 1-1-53	Production 1953	Per Cent of World's Reserves	Per Cent of World's Production
United States	28,945	2,360	21.2%	49.8%
Middle East	79,100	887	57.8	18.7
Venezuela	9,900	637	7.2	13.5
All Other	18,870	852	13.8	18.0
Total for World	136,815	4,736	100.0%	100.0%

These figures have startling significance, because (1) they reveal that more than half of the world's known crude oil supply lies within the reach of Russia, and (2) our domestic reserves are being consumed more rapidly than those of any other area in the world.

It is significant, too, to compare the kind of oil reserves developed in the U. S. with those developed in the Middle East. During the years 1946-1953, 602 wells were drilled in the Middle East. These wells accounted for a net increase of 60 billion barrels of proved reserves. During the same years something over 324,000 wells were drilled in the United States. These 324,000 wells accounted for a net increase of only 8 billion barrels of proved reserves. In 1952 the average Middle East well produced about 5,000 barrels of oil per day, while in the U. S. the average well produced only 13 barrels per day. During the years 1946-1952, only 24 dry holes were drilled in the Middle East compared to 91,755 dry holes drilled in the U. S. during the same years.

In the U. S. the more obvious and accessible structures have already been tested; therefore our present and future search must be extended to deeper formations, to the swamps, and marshes, and to the tidelands and mountains. Because of the unusual uncertainties and great costs inherent in such undertakings, the business risks involved in finding, developing, and producing oil and gas are greater today than at any time in the past. Without percentage depletion at its historical rate it is certain that the amount of capital risked in the exploration and development of oil and gas properties would be greatly diminished.

Percentage depletion provides the incentive for risking capital in the oil and gas business and gives assurance to the operator that the capital value found as a result of exploration and development efforts will be deductible for tax purposes.

There is another point that needs to be clarified. It has been argued that the depletion deductions allowed the oil industry should be limited to the cost of productive properties, because the money spent for dry holes and the intangible expense of drilling productive wells are deductible in the computation of taxable income. It is true that such losses and expenses are allowed as deductions, but this does not mean that all that is lost and spent is recouped in that manner. No recoupment results unless there is sufficient net income from profitable properties or other sources to absorb the losses. Even in those cases where the

losses and expense can be offset against other net gains, the recoupment is far from complete. Recoupment is always limited to the reduction in tax occasioned by the deductions. To justify his risks, a producer must be permitted to recoup from the income obtained from productive wells not only the cost of such wells, but in addition, all that has been spent for exploration, for leases and rentals, and for dry holes. The necessity and equity of this has been recognized by Congress since 1918.

The welfare of the nation is the foremost concern of the Congress. The Congressional policy on depletion was adopted and has since been continued, notwithstanding several Treasury Department recommendations to the contrary, because Congress believed that such a policy was essential to national security and domestic prosperity.

Has this policy achieved the intended results? For more than a quarter-century, percentage depletion has been a major factor in stimulating the exploration and drilling necessary to meet the growing need for petroleum fuels in our dynamic economy. In peace and war the United States' output of petroleum fuels has increased remarkably — by more than three times since 1926. This expanded supply has brought about marvelous changes in American life — it has made it possible for us to produce more with less work; it has made low-cost transportation available to everyone; it has provided us with comforts and conveniences unheard of a generation ago. Because of adequate supplies, prices have been low. Wholesale commodity prices generally increased about 80 per cent since 1926, while at service stations the price (excluding gasoline tax) of a much better grade of gasoline costs no more than it did in 1926.

Has the depletion policy given the oil and gas industry an unfair advantage over other industries? In view of the hazardous nature of the business and the necessity of such an incentive to attract risk capital, the industry needs the full depletion rate adopted in 1926 to keep pace with other industries. Statistics compiled by the National City Bank of New York show that earnings , after taxes, for about 90 of the largest and most successful oil companies during the 16-year period 1938-1953, were 12.8 per cent of net worth compared to 12.7 per cent for manufacturing companies and 12.7 per cent for trading companies. These same oil companies were not able to pay out as dividends as high a proportion of net profits as have the manufacturing

and trading companies, because they must retain more of their earnings in order to have the money to replace the oil that is constantly being produced.

I hold that these facts refute the statement that percentage depletion "favors a few at the expense of the many."

The nation's known supply of petroleum reserves is the result of long and continuous search for productive formations beneath the earth's surface. We must accelerate our exploration activities in order to assure that tomorrow's new discoveries will be adequate to meet future domestic and defense demands. Continuation of the present incentives and a political environment in which men are free to work, to compete and profit by their endeavors will make it possible for our industry to continue as an outstanding example of the American Way of Life.

Comments on Louisiana Conservation Act On Behalf of the Land Owners

By John A. Hickman,

Delivered at Biloxi, May 4, 1954,

Before Section on Mineral Law

Act 157 of 1940 is the modern conservation act of the State of Louisiana. As disclosed by its title, the declared purpose of the Act is to conserve the oil and gas resources of the State. Certainly, the Act is declaratory of the public policy of the State with respect to these natural resources, and the word "conservation" hardly needs definition. It means, plainly, to guard or to protect.

Because of the quite considerable financial investment required in the development of property and in the drilling of oil and gas wells, the land owner invariably sells this right to an oil company or operator in the form of a lease contract, under the terms of which, historically, and for some most obscure and antiquated reason, he received $1/8$ of the production obtained, and the operator or oil company the remaining $7/8$. Since the land owner is or will become the owner of such proportion of production, it is easy to see that he is most interested in conservation and in the prevention of waste and depletion of what he rightfully considers to be his property.

It would be academic to observe that the oil producer who owns or will become owner of $7/8$ of the production is, or should be, interested in a workable and acceptable Conservation Statute.

The local availability of oil and gas attracts and retains for the State many industries of various classification; the search for and development of oil and gas requires the employment of many thousands of people in the State of Louisiana and its economic relationship to other locally situated industries is of incalculable value. Thus we see that the State should also be vitally interested in the conservation of these irreplaceable resources.

When it is realized that the many millions of dollars annually derived by the State of Louisiana from the severance tax on oil

and gas are devoted to support of the public school system of our State, then it becomes apparent that every part and parcel of the State, every community, and every citizen should be vitally concerned with the conservation of oil and gas and other minerals which produce that considerable revenue in taxable form, and thus relieves them, in part, from the necessity of additional taxation.

Many of you as attorneys may perhaps not as yet have come to grips with the Conservation Statute, but with oil and gas still unpredictable as to location and deposition, its discovery may eventually occur at any given geographical location in Louisiana and any attorney may have occasion in the near future, if not already in the past, to be consulted by a client or land owner who has what I might term a "conservation problem."

To this point I think it must be admitted that the stated purpose of the Conservation Statute finds common agreement and support between the State, its citizens, the oil operator and the land owner, all of whom financially profit from an efficient and equitable conservation of the resources of the State.

For my part, I have carefully read the Statute on several occasions and can find no single provision with which I could find measurable quarrel, with the single reservation that there is entirely too much discretion vested in the Commissioner of Conservation — as I will endeavor to hereinafter illustrate — and I sincerely submit that any reasonable land owner who is aware of the provisions of the Statute, its purpose and the machinery set out for the accomplishment of that purpose, will agree that the Conservation Statute is, by its language, equitable and well designed to accomplish the ends of true conservation.

From all of this, it would seem to follow, without quibble, question or quarrel, that the Conservation Act should be well accepted, not only by citizens generally, but by the land owner particularly, who is most intimately affected by the Act. *Nothing could be further from the truth.* Blunt facts demand plain speaking. I know of no law or statute of more common unpopularity; more misunderstood; more misconstrued, or more reviled than Act 157 of 1940.

I do not know a single land owner, large or small, who, when he receives a notice, and if he receives a notice, from the Commissioner of Conservation of a public hearing which might affect

his ownership, does not, with fear and trepidation expect the very worst. How can this be so, it may be asked, if, as I have submitted to you, the land owner is in favor of conservation, and the Conservation Act is, in itself, a seemingly palatable instrument to achieve that purpose? As I humbly see it, the fault of the Conservation Statute, lies almost wholly in its administration. I hasten to add that I do not make this statement with reference to any individual who has served as Commissioner of Conservation nor to any member of his staff, who with him, are charged with administration of the Act.

The Act has the primary purpose of protection of the paramount interest of the State, and secondarily, equitable adjustment of the rights of individual land owners.

Insofar as the Act is designed to prevent the ruthless and wasteful exploitation of the mineral resources of the State of Louisiana by the oil industry, it has been, in my opinion, admirably administered by and large. However, insofar as the act, administered by a State official and State employees, may be considered as an instrument to afford protection to the large and small landowners who are citizens and tax payers of the State, and in many instances, without means of access to highly technical and prohibitively costly information with which to combat the ever constant and irresistable invasion by the oil industry upon conventional contracts and private property rights under the guise of "conservation," the Act and its administration has left much to be desired.

In a democracy such as ours, it is generally considered that a contract is a sacred instrument, and the average layman has long been led to believe that if he has an agreement with another in writing, that he has an inviolable instrument which constitutes the law between himself and his neighbor. With the advent of "conservation," our conception of the inviolability of contracts has been much modified, and particularly in the field of mineral law where the fact that the landowner may have absolutely conditioned the granting of a lease on his property to the express obligation that the lessee would, say, drill one well to every twenty acres, is all for nought when, after oil or gas is discovered and produced and the land owner calls on his lessee seeking to enforce the agreed development provisions of his contract, the producer or lessee can, and most likely does, apply to the Commissioner of Conservation for relief from that solemn

and voluntary agreement, and usually obtains such relief in the form of an order by the Conservation Commissioner that the producer or lessee need drill instead say, only one well to every 40 or 80 acres in the case of oil, and perhaps 320 to 640 acres in the case of gas.

This relief in favor of the producer is, however, in some measure consistant with the Statute and by it permitted and condoned. Nonetheless, if the Commissioner legally has such power to amend contracts upon a simple hearing and without resort to the courts, then I certainly assert that such power should not only be sparingly wielded, but only after due legal notice, full and impartial hearing and judicious study of the facts. For example, subsection (2) of Section 9 of the Act provides, in part, and I quote:

> "The portion of the production allocated to the owner of each tract included in a drilling unit formed by a pooling order shall, when produced, be considered as if it had been produced from such tract by a well drilled thereon."

To me, this language and the meaning of the Statute is clear, understandable and unambiguous. Let us now see how it was utilized in an order issued by the Commissioner of Conservation, and I quote now from Order #199, dated June 26, 1951, which provided in part as follows:

> "Production on any one of the tracts included within said drilling unit shall constitute production under the terms of each and every one of said lease or sublease contracts affecting the property included within the drilling unit.
>
> "The payment of said royalties and overriding royalties that may be due on gas and/or condensate, * * * when made in the above proportions, shall be and constitute full compliance with the obligations to make any payments under all contracts affecting the property included within said unit."

Please remember that the Statute says nothing about unit operation being or not being in compliance with the terms of a conventional lease contract, thus clearly inferring that such issues should be left to the courts to decide. In the cited order, it is apparent to me that the Commissioner, whose only jurisdiction, in the last analysis, is based on the conservation of natural resources and the prevention of their waste and depletion as a

matter of public policy, takes it upon himself in the administration of his duties to furthermore interpret private contracts.

Perhaps one can better understand the landowner's awesome aversion to a so-called conservation problem by a composite case which is assembled from the several hearings which I have attended.

First we start with the notice of the hearing: The Department of Conservation, on January 25, 1954, sent the following notice of a proposed hearing on the Big Lake Field of Cameron Parish, Louisiana, upon the application of Kerr-McGee. Here is what the notice stated, and I quote:

> "At such hearing, the Commissioner of Conservation will receive evidence relative to the adoption of rules and regulations governing the exploration for and the production of oil and gas, the establishment of drilling units, the utilization of separately owned properties to form drilling units, if necessary, and the method of allocating production from the 10,300′ sand in the Big Lake Field, Cameron Parish, Louisiana, being that sand encountered between 10,336′ to 10,346′ in the Kerr-McGee Oil Industry, Inc., #1 LeBleu Well, in the northwest quarter of Section 12, T. 12 S., R. 9 W. All parties having an interest therein shall take notice hereof."

Then follows the signature of the Commissioner, and this concluding paragraph:

> "A copy of this notice is being sent to all known, interested parties, however, all concerned will undoubtedly take notice of publication of public hearing in the State Times, Baton Rouge, Louisiana."

This notice was sent to a landowner who owned twenty acres situated approximately ¾ of a mile from this particular well, and which was under lease to an oil company other than the applicant, Kerr-McGee. First of all, despite what the notice may have implied, the so-called Big Lake Field consisted at that time of one single well. It is, of course, well nigh impossible for the average land owner ¾ or more miles away from this particular well, unversed in the Statute and its administration, and uninformed on the geological data derived from the drilling of a distant well, to discover from this type of notice if he is to be in anywise affected by such a hearing, particularly when no reference is made to either his lands, his lease or his lessee. You

will furthermore note that no size of units to be proposed is given or suggested in the notice, although in 99% of the cases, the operator and its staff of geologists and engineers and battery of attorneys have been devising and dissembling for probably a month or more on the problem of including as much acreage and as many leases as possible in their scheme of units. It must be assumed that they knew well before making their application the precise size, shape and extent of the units that they were going to propose, and were in every position to give notice of their intention in definite, concrete, and understandable language.

Please note also the concluding paragraph which advises a resident of Cameron Parish, Louisiana, that all concerned will undoubtedly take notice of publication of the hearing in a Baton Rouge newspaper. Bear in mind, also, that this notice is ordinarily received some ten or twelve days before the actual hearing in Baton Rouge, New Orleans, or Shreveport, either of which is some 150 or 200 miles removed from the particular area affected. The poor befuddled and bewildered landowner, if he has the time or money to go to Baton Rouge, New Orleans or Shreveport, usually presents himself at the hearing where, for the first time, he sees and is informed of the operator's unitization program. He is confronted with a welter and maze of geological and engineering testimony, discussions by geophysicists, paleontenologists, reservoir engineers, geological maps, subsurface correlations, core analysis reports, Schlumberger logs, cross-sections and hearsay testimony, at the conclusion of which a statement is usually made by the Commissioner in substantially this language:

> "Is there any other interested party who would like to come up and make a statement or would like to testify at the hearing?"

The landowner is thus given the incredible opportunity to defend himself on the apparent assumption that he is able to assimilate, understand, combat and defend on a moment's notice what is usually an hour's specialized and expert testimony resulting from months of study and planning.

Here again, as an administrative device, the Statute impliedly condones this procedure, in that it requires only that the Commissioner give ten days notice of a hearing in such manner and form as he may himself prescribe.

Of course, the Statute, in an almost lost and unremembered provision does provide that the Commissioner may elect to give notice of a hearing by personal service in a manner similar to that given by a court of law. However, it is current and has been past practice to send out an obscure notice to, and I quote, "all known interested parties" — that is, known to the Commissioner, who can hardly be expected to have personal up-to-date knowledge of land and mineral ownerships; and known to the particular oil company or operator who has requested the hearing, and of course, if, as a matter of fact, the interested party does not receive this notice, the Commissioner is entitled to assume, under the Statute, that such person will, and I quote, "undoubtedly take notice of the hearing as published in the Baton Rouge State Times."

I realize, of course, that the Act contemplates that the hearings shall be conducted in a more or less informal manner, but in my opinion, notice should, in all events, be sacramental. No one should be deprived of his property or his property rights without due process of law, and due process of law certainly entails and requires due and adequate notice and not "assumed notice." I recall that a bill was introduced in the State Senate some years ago which provided that whenever an application was made to the Commissioner for drilling units, that it had to be accompanied by a reasonable explanation of what was proposed, and a unit map accurately portraying the form and size of the units to be requested; that this explanation and the unit map would be maintained on file with the Commissioner and subject to inspection by interested parties for a period of not less than ten days prior to the public hearing to be held on the application. In other words, as I see it, that particular bill was aimed at giving minimal information to the land owner to be affected, large or small, who could not, under past and existing administration of the Act, determine just what he was going to be faced with until he actually arrived at the hearing. I might add that this bill never got out of committee, and I am informed was generally not favored by either the then Commissioner or the oil industry.

Since, as we see and must admit, the Commissioner has the practical power and authority to alter or amend voluntarily agreed to provisions of a solemn written contract, it should follow that in the exercise of that power, due observance to the legal amenities should at least receive some lip service in the

matter of the competency of the evidence on which the Commissioner will base his ruling. I have in mind a hearing which I attended some years ago in Baton Rouge where the whole crux of the question was whether or not the operator had a market for the potential gas production from several shut-in gas wells. The Commissioner intimated by statement in the record, that if the operator had no market, then the application for units was premature, but that if, indeed, the operator had an immediate market, that he thought the units should be established. The oil company who applied for the hearing had a representative present, who was not even a company official, who testified, and not even under oath at that, that his company had entered into a long term contract for the sale of gas, and was ready to market that gas as soon as the Commissioner issued the requested order. Unversed in what I later learned were the customary proceedings, I asked the witness if he were prepared to produce the original or a duplicate of this contract, to which he referred, in order that the Commissioner and the interested parties, including the landowners, might verify his testimony. Objection was made that this was, and I quote, " a third party contract," and that it need not for such reason, be produced. The Commissioner agreed with the objection and ruled, in effect, that the statement of the witness was sufficient proof of the contract. Such procedure, gentlemen, is to my mind, incredible in view of the fact that the Act expressly provides that the Commissioner may, and I quote, "issue subpoenas requiring the production of books, papers and records in any proceedings before the Commissioner, as may be material upon the questions lawfully before him."

Generally speaking, if the landowner or his attorney, most of whom, like myself, do not have the technical knowledge or skill necessary to properly cross examine these specialized experts in the mineral field, have the temerity to question a geologist, engineer, or other expert of the producer, he will usually not only be met by seemingly authoritative technical replies, references, maps and data, but a good measure of hearsay testimony thrown in to boot. I recall such a witness on behalf of the operator being questioned concerning the correctness of his structural interpretation making a reply such as "I talked with XYZ oil company's geologists and engineering department some months ago, and they agree with me 100%"; or he or the oil company attorney might produce a letter or a telegram from

some other oil company stating that their experts had studied the matter and were in entire agreement with his particular testimony, interpretation or views. I submit to you that "mail order evidence" of this nature, or call it what you will, has no place in any proceedings, formal or informal, where the sacred contract and property rights of the citizens of the State of Louisiana are at stake.

At page 502 of Volume 17 of Wests La. R. Statutes, there is a preface entitled "The Conservation Laws and Their Administration," in which reference is made to the staff of the Geological Survey, and it is expressly stated that this staff makes independent studies of the geological problems involved in the administration of the Act, and such studies are especially valuable to owners of small tracts and royalty interests. It being expressly stated that in many instances information gained through studies by the staff of the Geological Survey furnish the only geological information available to these owners of small interests. From this it might be inferred that there does exist, after all I have said, in the framework of the act and its administration, a protection for the small, and otherwise unrepresented land owners. However, so far as I can ascertain, the members of this Louisiana Geological Survey are themselves a part of the Commissioner's staff, and do not function as an entirely separate and independent body. Furthermore, so far as I am able to ascertain, there is no information volunteered, proffered or made available to small land owners or their representatives *prior* to a Conservation hearing. Indeed, in an endeavor to give adequate protection and attention to the rights and privileges of the landowner, there was proposed to the Senate of Louisiana some years ago an Act to create an oil, gas and mineral commission, whose specific duties were to represent, advise and counsel any resident owner of a mineral interest, exclusive of producers, before, during and after the hearings held by the Commissioner of Conservation. This commission was to be composed of two attorneys at law, experienced in the practice of mineral law, one petroleum engineer, and one geologist. This bill, like most of its kind seeking to assist and give adequate aid and protection to the landowners of Louisiana, independently of the Commissioner, never got beyond committee stage, and I am informed was unacceptable to spokesmen, lobbyists and representatives of the oil industry.

A most searching observation was made by Judge Fournet, Chief Justice of the Supreme Court, in his dissenting opinion in

the case of Alston v. Southern Production Co., 21 So. 2d 383, pointing up the administrative failure of the Act to afford adequate protection to the small landowner, in the following language, and I quote:

> "In other words, if the holding of the majority opinion is allowed to stand, the property rights of small property owners can, to all effect and purpose, be confiscated or else rendered valueless, for such a property owner, not being able to maintain at yearly salaries the geologists and experts at the command of the State and the large companies, is unable to produce expensive scientists and experts as witnesses at or bear other expenses incidental thereto, at such hearings indefinitely."

As an example of where the rights and privileges of the small land owners are lost and forgotten in the administrative phases of the Act, I have in mind a small field in Southwest Louisiana, which must remain nameless, for the present. In that field, on the basis of only three wells, only two of which were producers, the Commissioner of Conservation established two units of approximately 490 acres each. Subsequent to the issuance of the order, there were drilled offsetting these units in each of the four compass directions, four dry holes, which established as reasonably as geologists can establish such things, I am told, the fact that a considerable portion of the unitized acreage was nonproductive, and of course, had never been productive.

This inequitable situation, whereby productive acreage contributed royalty to nonproductive acreage, was permitted to continue for more than a year by the producer, who owned all of the leases in the affected area, and of course, did not care to whom or to how many land owners it paid the minimum of 1/8 of production, and as a matter of fact, apparently thought it was obtaining good will through such a wide distribution of royalties without regard to equity. Of course, the Commissioner of Conservation could not independently initiate corrective measures — rarely is there either opportunity, time or personnel to permit the Commissioner to reopen or reconsider field rules unless application is made to him by other interested parties.

I have no comment to offer, but leave to your judgment a situation which resulted from hearings called some time ago on a field in Southwest Louisiana. This hearing was held on several consolidated applications. Some were called by the several producing oil companies, and others by a group of landowners

who felt, and I think with some little justification, that there were long standing inequities under existing orders for the field. Several weeks after the hearing, which, mind you, considered not only the application of the producing companies, but those of the land and royalty owners as well, the Commissioner sent out tentative orders to the operators under circumstances that seemed to imply invitation that they offer any appropriate comments or suggestions. So far as I am able to ascertain, no copies of such orders were sent to any landowners involved. I am certainly of the conviction that the interests of the State were protected in that particular instance, but it appears equally clear to me that there was demonstrated little respect for the feelings and equal privileges of the considerable number of land, mineral and royalty owners involved in that specific conservation problem.

Despite the foregoing comments and illustrations which I have given you in a sincere effort to view the Conservation Act and its deficiencies from the landowner's point of view, I am firmly of the conviction that conservation of oil and gas is an absolute necessity, and that to accomplish that purpose, forced unitization or pooling is a necessary adjunct. Once concede that Conservation requires the formation of drilling units, then of necessity it must follow that the Commissioner should have the power to compel the landowner to contribute his acreage to the units so established, and with these phases of the Statute, I can find no reasonable quarrel. I would furthermore frankly admit that in the administration of the Act, any Commissioner and his staff face a herculian task when we consider that at the semimonthly hearings of the Conservation Commissioner, in addition to considerable other business, there are usually heard an average of about five applications dealing principally with the creation of drilling units, and in each instance, the technical evidence is presented by geologists or engineers who have had a month or more in the preparation and assembly of the work and data — it is simply not physically possible, in my opinion, for such a limited staff as the Commissioner must now work with, and the limited time he and his staff can devote to a given problem to adequately protect the correlative rights of the individual small landowner. But this is hardly valid excuse for the standing problem of the landowner for the past thirteen years, or more.

There is a widespread and I hope contagious movement being started in this State by land and royalty owners associating with

the common purpose of better protection of their individual rights in dealing with the oil operators not only at the contractual level, but more principally, at the hearings of the Conservation Commissioner.

This show of unity should be encouraged to the end that legislation may perhaps be enacted to afford the Commissioner of Conservation with an adequate staff with which to approach conservation problems, not only from the standpoint of protection for the overall interests of the State, but with more and particular emphasis on the rights of the individual landowners of the State, or perhaps there may in the future be established within the framework of the Act, a commission of qualified persons charged with the specific obligation and duty of insuring that the correlative equities of landowners shall be established and maintained in the rulings of the Commissioner of Conservation, for indeed it does not follow in any given case that protection of the mineral resources of the State necessarily results in adequate or substantial justice being done as between small landowners *inter se* and as between these landowners and the producers. These objectives can, and must, of course, be supplemented by a more rigorous and legalistic administration of the Act, particularly with reference to the requirement of real, actual and comprehensive notice of hearings, and stricter adherence to accustomed rules of evidence, both of which procedures are expressly provided by the existing Act and still remain at the utilization of the Commissioner if he be persuaded to employ them.

Perhaps my views have been too critical and my opinions too radically stated, and if such be the case, I am sure that Mr. Carroll, who follows me in answer, will temper your judgment on the Conservation Statute.

Investigation Into Representation of Indigent Criminally Accused

Report of Floyd J. Reed,
Junior Bar Council Representative
from the First Congressional District
to October 30, 1954 Council Meeting
at Baton Rouge, Louisiana

". . . The accused in every instance shall have the right to be confronted with the witnesses against him; he shall have the right to defend himself, to have the assistance of counsel, and to have compulsory process for obtaining witnesses in his favor." (Art. I, Sect. 9, Louisiana Constitution of 1921, as amended).

The above quoted words are as succinct and accurate a description of the Anglo-Saxon tradition of fair play in criminal prosecutions as will be found anywhere, and we are proud to report, as will be seen, that it is contained in the Constitution of the State of Louisiana.

It is quite clear, then, that in any criminal prosecution, be it felony or misdemeanor, the accused is entitled to, among several very vital implements to aid in his defense, the right to legal counsel.

Since the legal profession in this country has always prided itself on its vigilance in guarding human rights, we proceed to find out what steps the profession in one particular place is taking to make the constitutional mandate a reality. Acting on a resolution of the Council of the Junior Bar Section of the Louisiana Bar Association, the writer of this report conducted the preliminary research which forms the basis of this, a preliminary report. (In the final report, it is hoped that we will be able to demonstrate the conditions in every part of the State of Louisiana on a representative basis and make the necessary recommendations to alleviate distress wherever it may be found.)

Investigation by the writer reveals that in the State of Louisi-

ana, there are presently legal aid societies at Baton Rouge, Shreveport, and New Orleans.

Generally, all over the United States, legal aid does not handle criminal cases. New Orleans is almost unique in that the Legal Aid Society, which is supported by the Red Feather agencies and by the local bar association, has both a civil and a criminal section of legal aid. It was developed that, from the period of 1942 to 1954, the New Orleans criminal section of the Legal Aid Society handled between 400 and 450 cases per year, which included capital cases, felony cases, misdemeanor cases, and cases where material witnesses, unable to post bond, were held in the Parish Prison. The Legal Aid Society, of course, undertook to file the necessary motions to have the testimony of these witnesses perpetuated, and thereby obtain their release from incarceration.

This number, which is cited above ,has represented over a period of time about 20% of the total number of prisoners incarcerated in the Parish Prison who were unable to post bond, or who were held on capital charges.

This work load has been handled by one full-time attorney who has recently been raised in salary to the point where he is now making about $6,000.00 per year; and he is assisted by a part-time man, who, information reveals, is paid about $150.00 per month.

The Legal Aid estimates that they try from four to six cases per month. The balance of the cases are disposed of on pleas of guilty or worked out with the District Attorney's Office, with a very small number being nolle prosequed.

Further investigation reveals that the appointment of private members of the Bar in the six divisions of the Criminal District Court for the Parish of Orleans, runs to about two hundred appointments per year, more or less. These appointments are generally made from the junior members of the Bar who have the time to devote to such cases. This figure does not include the Magistrate's or the Traffic Court. The services rendered by these lawyers are not compensated for from any source whatever.

The writer has been unable to find a single instance wherein counsel was appointed to assist in a defense in the Magistrate's Court or in the Traffic Court. While it is true that these are

misdemeanor matters, nevertheless they are matters in which a person stands to be deprived of liberty or property, and is entitled to full and due process. And full and due process includes representation from the Bar.

The writer herein recommends that several simultaneous investigations be commenced in the several parts of the State to determine if the situation is similar to the situation in New Orleans, or if it is better or worse; and in due course, the reports should be assembled for study by the Criminal Law Committee.

The writer assumes from hearsay picked up at various convention meetings, that the situation is certainly not better in other parts of the State than it is in New Orleans; and acting on this assumption, takes the liberty of citing the need for a statute.

The statute which the writer believes there is a need for should provide authority for the judge to order a warrant to compensate the members of the Bar who are appointed to represent the financially indigent in criminal prosecutions. Such a statute is not new; New York, for example, has such a statute, but the writer is not prepared to give a full report on the said statute.

From observation, it is believed that generally the statute should provide that the Clerk of Court, or some such officer, should keep two rosters of attorneys who desire criminal appointments. One of the rosters should be maintained for attorneys who have been practicing for less than five years, and the other roster should be maintained for the names of the attorneys who have been practicing for more than five years, since the code of criminal procedure prohibits the appointment by the Court of lawyers in capital cases with less than five years of experience at the Bar.

The attorney, then, who is desirous of having his name enrolled on the appropriate roster, may have his name placed thereon by presenting a motion and order to the Court directing the clerk to inscribe his name on the appropriate roster.

When the Court finds it necessary to make an appointment of an attorney to represent an indigent criminally accused, it may instruct the clerk to notify the attorney whose name is first on the appropriate roster in much the same matter as the citation of curators ad hoc is made. When this appointment is made, the attorney's name then is placed by the clerk at the bottom of the roster so that it may work its way up to the top

again by the successive appointments of those whose names subsequently appear at the top.

For further convenience, the statute may direct that the cases be divided into four classes; first class, capital cases; second class, felony cases necessarily punishable by life imprisonment or hard labor; third class, cases not necessarily punishable at hard labor; and fourth class, misdemeanor cases.

Compensation to be paid to the attorneys can then be arranged on a scale according to the class of the case, either fixed or fluid, depending upon which is considered to be the more expedient by the legislature. If it is fixed by means of a sliding scale, the rate of compensation may be determined by the Court, within limits, on the basis of the work load, such as:

Class 1 Case — $1,500.00
Class 2 Case — $500.00 to $1,000.00
Class 3 Case — $250.00 to $500.00
Class 4 Case — $100.00 to $250.00

In class 1 and 2 cases, the Court may at times deem it expedient to appoint two attorneys in the case, in which case the Court would order the fee split.

Alternatively, if it is deemed advisable to have a fixed and set fee for each class of case, then it is suggested that a fee schedule should be set up for the various offenses in the Criminal Court in much the same manner as the schedule of special damages is set up on the Workmen's Compensation Act.

There are, however, two problems which must be solved and which are submitted to this Committee for consideration.

They are: (1) The gathering of the necessary information as to what situation exists in the various parishes representatively; and (2), the source of revenue which the statute would tap to provide the appropriation to meet the compensation of the attorneys.

The first problem can be met by assembling the reports from various parishes, based on investigation made by members of the Bar in the several parishes; but the second problem must be met by a realistic study of the State and Parish revenue situations, since a hasty proposal of a source of revenue may find itself flat against the wall of some local situation which would result in opposition to the statute therefrom.

The Importance of Comparative Property Law to Louisiana Lawyers

By Leonard Oppenheim,
Professor of Law, Tulane University,
Before Section of International Comparative Law
Biloxi, Miss., May 4, 1954

In order to understand the basic differences which exist between civil and common law theories of property, it is necessary to examine the historical factors which were responsible for such differences. Let us first consider the civil law system. Roman law, which underlies most modern codifications, reached its highest point of development by the year 200 A.B. The writings of such men as Gaius, Papinian, Ulpian and Modestinus accounted for this development and were the source material for the great codification of Justinian, the Corpus Juris Civilis. After the fall of the Roman Empire, Roman law still exerted a profound influence. Many of the so-called Germanic Codes of the 5th and 6th centuries bear the strong impress of Roman law.

With the collapse of the Holy Roman Empire, which had been instituted by Charlemagne, weakness succeeded power. Centralization was followed by a dismemberment of authority and its localization in the hands of the nobles. Each separate state provided for itself and the existing codes sufficed. Upon the remnants of imperial authority the new feudalism grew up. Customary law also played a part in this period and was formed practically by the feudal classes to protect their interests.

With feudalism, the principle of the territoriality of laws makes its appearance. In each feudal lord's domain, the local "Custom" and only the local "Custom" would be applied. This principle of the territoriality of the laws brought about two results: first, the division of France into two sections or regions — the region of the Written Law and the region of the Customary Law, which division was to persist until the promulgation of the French Civil Code in 1804 — and second, the feudal rule that all

customs are real, i.e., the sole law to be applied within a given territory.

In Southern France, where the Roman population greatly outnumbered the Germanic, Roman law became predominant in the region. In Northern France, however, mixed remnants of Germanic and Roman law, the Canon law and local usages made up the customary law. Thus, even in the region of the Written Law, local customs were important and Roman law still had some influence in the region of the Customary Law. By the end of the sixteenth century, all of the various Customs or "Coutumes" had been reduced to writing and promulgated.

It has been stated that the dominant characteristic of the French Revolution was a hatred of feudalism and especially of civil feudalism. Land ownership had been closely bound up with the ancient social organization. Therefore, there was a mass of rights and usages, arising out of feudalism and affecting human relationships so that there were special privileges benefiting certain lands and certain persons. As a result of the French Revolution, the eminent domain of the nobles was abolished and with it all the rights which were directly or remotely connected with public office. Simple tenants were raised to the rank of full owners and acquired the right to dispose of their lands without seigniorial intervention.

Feudalism had thoroughly burdened the land with all sorts of dues, rent-charges, quit-rents and tithes. The right of ownership which had once been simple and undivided, had been separated into the beneficial ownership and the direct or superior ownership and there were rights which were inalienable and irredeemable. All of this mass of confused rights was wiped out and ownership became once more absolute and complete, like the Roman dominium.

When the French Civil Code of 1804 or Code Napoleon was drafted, the principal sources were the Customs (especially the Custom of Paris), Roman law, the Royal Ordinances and the Revolutionary Laws. It is important to note that the Roman law served as the basis for the system of ownership which was adopted in the new Code.

As we all know, Louisiana from the beginning of its history was influenced by civil law concepts. The introduction of the Custom of Paris by the French in 1712 and Las Siete Partidas the great Romanist codification of Alfonso XI by the Spanish in

1769 both laid the foundation for the later Louisiana codes. When James Brown and Moreau Lislet were appointed to compile and prepare a civil code for the Territory of Orleans, they took as their model the Code Napoleon or the draft of that code of the year VIII and added Spanish and Roman law elements.

The Louisiana Civil Code, which contains over a thousand more code articles than the French Civil Code, adopted the threefold classification of persons, things and modes of acquiring the ownership of things. This division of the civil law into three categories, which is generally attributed to Gaius, was taken from the French Civil Code. Book II of the Louisiana Civil Code which treats "of things" represents the result of French, Roman and Spanish influence. It consists of 422 articles as compared with 194 in the French Civil Code. In many instances the concepts are identical with or similar to the French but in some instances definitions and distinctions are derived from other sources. These other sources were the French doctrinists, especially Pothier, the projet of the French Civil Code which is ascertained from the fact that some provisions are found in the projet but omitted from the Code Napoleon itself, the Corpus Juris Civilis, especially the Digest, the Spanish doctrinal writers, especially Febrero, and Las Siete Partidas.

Ownership, according to Article 488 of the Louisiana Civil Code, is the right of the individual to control and enjoy a thing to the exclusion of all others. It consists of three basic elements: usus, the right to use; fructus, the right to the fruits; abusus, the right to alienate. While perfect and imperfect ownership are permitted, the situations in which a division of these basic elements are allowed to occur are jealously guarded. Moreover, the Civil Code clearly points up two fundamental principles of civil law: first, a thing must not be removed from commerce for an indefinite period by restrictions upon use or disposition; and second, wherever possible, the three basic elements should be reunited as frequently as possible so as to restore perfect ownership. This general policy of the civil law of preventing a division of interests and a tying up of property is further illustrated by the requirement that the beneficiary of a grant, whether inter vivos or by testament, must be in existence at the time of the grant or at the death of the testator. Moreover, the prohibition against substitutions and *fidei commissa* of Article 1520 also bears this out. Thus, because of its civilian background, Louisi-

ana's property law as set forth in the Civil Code is in accord with fundamental civil law doctrines.

Let us now examine the historical background of the common law property system. Land law was the most important part of common law and the most highly developed. Throughout its period of development, which, incidentally, is still going on, the process has always been one of building upon a pre-existing structure. Statutes and decisions can be understood only in light of the common law background. Moreover, many institutions have had the hardiness to survive the passage of time. It delights all property professors to point out that it is possible to set up a type of estate in land in South Carolina which existed in England between 1225 and 1285 A.D.

The usual starting point for a study of common law property is 1066 A.D., the year of the Norman Conquest. After the defeat of Harold at Hastings, William the Conqueror entrenched feudalism as a governmental and landowning system. In the eleventh century Normandy was a highly developed feudal state and William brought this system to England. Theoretically, all lands became forfeited to the king to be regranted to his followers. While at first William only succeeded to the lands held by Harold and his leading nobles, by additional conquest and commendation (the process of placing themselves under a Norman overlord by Saxon landholders), William brought under his aegis a substantial part of the land. As a direct result of the system of forfeiture, commendation and regranting, the doctrine of tenure was instituted. No one could own land absolutely but only an interest in the land under and subject to a superior person. The king was then the lord paramount; those who received from the king were "tenants in capite" while those who held under the "tenants in capite" were the "mesne" or intermediate tenants. The lowest in order of the land owning class were paravail tenants, so-called because they were to make "avail" or profit of the land. Thus, the system of tenure was like a pyramid with the king at the apex.

There were four types of land grants or tenures that were used by William and his followers: (1) Military tenure, i.e., the furnishing of a certain number of knights fully armed for a period of forty days; (2) Socage tenure, i.e., the furnishing of a certain amount of agricultural products or a certain periodic payment of money; (3) Frankalmoign tenure, i.e., the furnishing

of church services for the giver's soul by the church to which the grant was made; and (4) Serjeanty tenure, i.e., the furnishing of household services, such as those rendered by stewards or marshals, by the grantee. The burdensome aspect of the tenure, however, was not the services required but the incidents. These were aids, control of wardship and marriage, fines on alienation, relief and primer seisin, homage and fealty and escheat. Distortions and abuses surrounding these incidents gave rise to a movement to simplify the whole system and remove its most objectionable aspects. The process took 370 years, from the Statute Quia Emptores in 1290 which prevented further expansion of the feudal systems to the Statute of Tenures in 1660 which struck English feudalism its death blow. By the Statute of Tenures, all military or socage tenures were changed into free and common socage tenure. The most burdensome aspects of the incidents were removed. All that remained of the earlier tenurial system were escheat, relief, as a form of succession tax, and the basic idea that all land is "held" rather than owned.

Gradually and as the result of several factors, common law was received into most of the American colonies. Many of the original land grants were made in free and common socage such as the grant made to William Penn wherein the services to be rendered were two beaver skins annually. On the whole, the services rendered were annual small sums of money called quit-rents. However, in New England quit-rents were exceptional and were abolished long before the Revolutionary War. After the Revolutionary War, the state replaced the English Crown as sovereign. In many states statutes were passed abolishing tenure and providing that lands should be allodially owned. In other states tenure exists with the state as overlord and Quia Emptores is in force. In Pennsylvania and South Carolina, tenure exists and Quia Emptores has been held not to be a part of the common law as received in those states. As it has been worked out, however, it makes little difference whether tenure does or does not exist.

One factor of tremendous importance to point out in this analysis is that while the French feudal system became corrupt to the extent that it became necessary to completely abolish the entire system, in England the system was flexible enough and yielded sufficiently to corrective legislation that many principles developed at that time still survive today. While significant changes have been made through decisions and statutes, these

can be understood only in light of historical background.

Mention must be made of the unexecuted use which enabled the Court of Equity or Chancery to provide for the trust. The two systems of law and equity enabled the trustee to have legal title with equitable title in the cestui que trust. Thus, it became possible for a person to transfer property to a trustee to be held for the benefit of a third person.

Obviously the difference in historical backgrounds between civil law property and common law property has produced essentially different systems. Compared to the relatively simple civil law system, common law real property seems involved and unseemingly complex. Yet, the question remains, "What is the importance of Common Law Property to the Louisiana Lawyer?" Should he ignore it with a thankful prayer that his system is not nearly so cluttered with ancient doctrines or should he attempt to understand its principles? Just as no man is an island unto himself so no state can be an island unto itself. Common law property has importance to Louisiana lawyers for a number of reasons. First, certain common law doctrines have been brought into Louisiana law such as the quit-claim deed, covenants running with the land, uniform building schemes, etc. Second, Louisiana lawyers often must interpret or consider documents drawn in other states which affect property rights. Third, many of the tax laws are drafted with principles of common law property in mind. Fourth, the introduction of a limited trust act into Louisiana makes essential an understanding of common law trust principles. Fifth, the importance of estate planning requires a knowledge of common law property principles by Louisiana lawyers. While an examination of the entire field of common law property would not be feasible unless we had unlimited time, let us examine a number of principles which are peculiar to common law property and are unfamiliar to attorneys in Louisiana.

While concepts which are similar to common law joint tenancy and tenancy by the entirety do not exist in civil law, because of their importance in other states the Louisiana attorney should be familiar with the characteristics of each type of tenancy. In a joint tenancy, each joint tenant is thought of as owning the whole, subject to the equal rights of the others. Upon the death of a joint tenant, the entire joint property is vested in the surviving tenants. However, during the lifetime of the joint tenants, the survivorship feature may be destroyed. This

may be accomplished by partition, by mutual agreement or by a conveyance of one of the tenant's interest to a third party. The tenancy by the entirety is a form of co-ownership of property which is limited to the husband and wife. There is also survivorship in this type of tenancy and it is usually severable only by divorce. Since a considerable amount of real estate and bank deposits are owned by husband and wife in joint tenancy or tenancy by the entirety, a great many tax problems have arisen concerning these tenancies. Moreover, the use of property so held for marital deduction purposes, has solved some of the tax problems regarding these estates but has in some instances created new ones.

The civilian has his greatest difficulty in understanding common law future interests. The scheme of estates in land with certain interests being vested and others contingent seems to him complex indeed compared to his own system. It is important, however, for the Louisiana lawyer to have some knowledge of how the common law system of estates operates. Interests at common law are either freehold or nonfreehold. Freehold estates are of uncertain duration while nonfreehold estates always have a definite period of duration. The principal freehold estates are the fee simple absolute, the qualified fee simple, the fee tail and the life estate, while the nonfreehold estates are term for years, periodic tenancy, tenancy at will and tenancy at sufferance.

The fee simple absolute is the greatest estate known to common law and today is tantamount to absolute ownership. The qualified fee simple is usually qualified by some limitation which, if violated or not observed, may terminate the estate. For example, "To X and his heirs as long as the property is used for church purposes" or "To X and his heirs provided that the property is used for church purposes but if the property is not used for church purposes, the grantor or his heirs may re-enter." The fee tail is a conveyance to a grantee and the heirs of his body. In the United States the fee tail has been considered unsuited to American social conditions and was never used to any great extent. The life estate is a granting of an estate for the life of a person with a reversion in the grantor and his heirs or a remainder to some other person or persons. The life estate is rarely created except in some will situations.

At common law, the grantor can carve up the property into a number of estates. He may create estates of present enjoyment

and also ones in which the enjoyment in possession is postponed. If A owning land in fee simple absolute conveys "to B for life, remainder to C and his heirs," B has a life estate, a present possessory estate, while C and his heirs have a remainder or a future estate. Future interests permitted at common law are: (1) possibility of reverter in a qualified fee simple; (2) right of entry for condition broken, also in a qualified fee; (3) reversion, wherein the grantor has reserved the residue of the estate in himself; and (4) the remainder, wherein a transferee takes after the present estates expire. Remainders are divided into two classes: vested remainders and contingent remainders. A remainder is vested if it is given to a born and ascertained person and no condition precedent is attached to it, while a remainder is contingent if it is given to a person who is unborn or unascertained or it is subject to a condition precedent. A contingent remainder is not an estate but merely the prospect or possibility of becoming one. Thus, it is possible at common law for X to grant an estate "to B for life, remainder to B's eldest son and his heirs" even though B is childless at the time of the grant. From these simple rules can come a multiplicity of complex situations.

Frequently at common law the beneficiaries of a disposition are described by reference to their membership in a group such as "heirs," "children," "issue," etc. Many problems are raised by such a designation. First, the problem of whether the gift is to an individual or to a class; second, when does the class close to any possible additions; third, the time that the class member must survive in order to take a portion of the gift; fourth, the application of lapse statutes to the class gift, etc. Often the problem resolves itself into one of careful drafting and litigation is avoided by the draftsman's concern for the dangers lurking in the use of certain words to describe the class. The technique used for the solution of class gift problems is "first, the formulation of a rule of construction based on the probable desires of an average person familiar with all circumstances; and second, a recognition of many factors which will tend to overcome the applicability of the rule in the particular case."

When future interests are created, the Rule against Perpetuities is not a rule which invalidates interests which last too long, but rather those which vest too remotely. Should the interest fail to vest within the period of the Rule against Perpetuities, such interest is invalid.

Where different situations are involved, the date from which the Rule against Perpetuities commences to run becomes highly significant. Thus, the interest to be considered may exist in an irrevocable inter vivos trust, a revocable inter vivos trust or a will or it may be in a class gift, a power of appointment or an accumulation. The attorney must be aware in each situation when the period begins to run so that he may determine when all interests will vest. Careful drafting can avoid violations of the Rule and if correctly done, the Rule can be complied with and the desires of the settlor or testator can be satisfied.

At common law a power of appointment, which is not permitted in Louisiana, exists "whenever a person has the discretion to determine what persons are to receive beneficial interests in property or to determine the amount of beneficial interest in property to be received by certain persons." The principal classifications of powers of appointment are: (1) general powers and special powers; (2) powers to appoint by deed only, powers to appoint by will only, powers to appoint by will or deed; (3) powers presently exercisable and exercisable only at a future time; (4) powers purely collateral, powers appendant and powers in gross; and (5) powers in trust and powers not in trust. Probably the most important classification is that of general powers and special powers. When the donee of the power can appoint to himself or can direct distribution of the appointed property as part of his estate, the power is general. On the other hand, when the donee's appointment is limited to a group which does not include himself or his estate, the power is special.

Where a general power of appointment exists, and there is no provision for a gift in default of appointment, the property goes to the donor or to his estate if the donee of the power fails to exercise the power. However, if the donor has disposed of the interest in default of appointment, and the power is not exercised, the property goes to the persons so expressly designated by the donor of the power. A power of appointment is terminated by its exercise or by the death of the donee who fails to exercise the power. The power may also be released, i.e., completely or partially released by the donee, or revoked by the donor, if such a right is reserved.

Powers of appointment have had great importance from the standpoint of federal gift and estate taxation. The latest enactment, "The Powers of Appointment Act of 1951" completely rewrote the federal estate and gift tax laws relating to powers

of appointment. This new act is based primarily upon two fundamental concepts; first, as to powers created before October 21, 1942, for estate tax purposes, the laws applicable would be those in force when the power was created, and second, as to powers created after October 21, 1942, such property as covered by such a power would be included in the donee's gross estate if it is general, as defined by the Act. A general power of appointment is defined in the Act as one which is "exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." In present day estate planning the use of powers of appointment adds flexibility to an estate plan and has been an important device for minimizing taxes at common law.

Before leaving this phase of our subject, let us consider how problems may arise in a conflict of laws situation. The Louisiana attorney may be faced with conflict of laws problems in a number of cases. However, it is in the field of trusts that such problems are most likely to occur. When a trust has been set up in another state, which affects property located in Louisiana, it is unlikely that Louisiana courts would give validity to provisions in that trust which contravene civil law doctrines. The non-Louisiana attorney assumes a tremendous risk where such provisions are concerned.

Even should the Louisiana lawyer set up an inter vivos trust in another state and the property is actually transferred to the trustee in that state, all problems have not been solved. If the trust deprives the surviving spouse of community property rights or impinges upon the legitime, Louisiana courts may be willing to recognize these rights as to the testator's property remaining in this State. Whether the courts of the state where the trust is located would recognize such rights as those of a forced heir is an interesting but unsolved question.

When trusts have been created outside of Louisiana, the Louisiana lawyer must consider conflict of laws problems relative to the law controlling formality, capacity, construction, administration and validity of the trust. In addition he may be faced with conflicts situations as to wills, donations and other aspects of estate planning. The Louisiana attorney, whose client has had instruments in his estate plan drawn outside of the state, should examine such instruments with great care in order to determine their effect. In some instances redrafting may be mandatory.

With a recognition of all of the above factors, we at the

Tulane Law School have instituted a comparative property course in the first year of study called "Introduction to Property." This course, which as it happens, is taught by the speaker, cannot hope in the period of time allotted to it to cover all fields of property law. However, the course does deal with personal property, lease, rights in land, civil and common law backgrounds and concurrent interests. If an "apologia" is necessary for such a course, Professor Stone of our faculty has well stated the reasons in an article in Volume 22 of the Tulane Law Review entitled "On Teaching Law Comparatively." On pages 160 and 161 Professor Stone writes: "At the outset, it is well for the author to state his own predilection, namely, that 'comparative law' is not a subject in itself to be included in the catalogues and curricula of universities; rather, it is a method which can be applied to the study of all law either particular or general. The practice of comparing is one of the most deep-seated of human traits. Man compares one event with another, one object with another object, one reaction with another, one person with another person. The bases upon which comparisons are made, the methods by which the results are evaluated may vary but the fact of comparison remains as a basic element of the process of learning.

"The student of today is trained in national law. He is taught to compare the 'rule in Illinois' with the 'rule in Massachusetts.' He has perforce become aware of the disparity of legislative actions and the variation of judicial determinations. He has become interested in the comparing of law, partly because the interest or nature of his future clients so demand and partly because he has taken his place in the process of a series of states becoming a nation. . . . . it must be noted that people marry without considering the difference of nationality, that they travel and sometimes die in countries which have quite different laws from our own. If our lawyers are to represent these potential clients, they must bestir themselves in research."

In this property course we approach the subject matter involved first, from the standpoint of basic concepts and second, from the standpoint of specific examples of the problems to be solved. Sometimes our analysis includes Louisiana, French and common law. The case of Port Finance Co. v. Ber, 45 So. 2d 404 (La. App. 1950) furnishes an excellent illustration of this approach. "A" sold an automobile to "B," who misrepresented himself as "X," and gave "A" a forged check in "X's" name. "B"

thereupon sold the automobile to "C" who purchased for value and in good faith. "A" brought suit against "C" for restoration of the automobile or its value. The lower court's holding for "C" was reversed on appeal on the ground that "B's" acquisition of the automobile constituted theft under Article 67 of the Criminal Code and no title passed to "B" or his vendee even though "C" was a bona fide purchase. An examination of common law reveals that the majority of jurisdictions would have protected "C" since there was apparently the intent on the part of "A" to pass title to "B" and not merely possession. An examination of French law reveals that "C" would be protected under the doctrine of "la possession vaut titre" since theft would involve a taking not only without "A,'s" knowledge or consent but by a "force majeure." An examination of Louisiana law reveals that the courts have followed the bona fide purchaser doctrine and yet, in this case the court severely restricts the situations in which a bona fide purchaser would be protected. Thus, Louisiana is placed in the singular position of being opposed to both civil and common law. Such an analysis is not only of tremendous interest to the student, but constitutes excellent legal training.

In many instances we find that the rules of both systems are quite similar even though terminology may differ. I was quite intrigued to find a long note in the January, 1954 issue of the Wisconsin Law Review devoted to a comparative law study of illegal and immoral contracts. In his conclusion the author makes this statement: "Starting with two contrasting attitudes and approaches to law, the civil and common law countries have reached surprisingly close results in the area of illegal contracts." Perhaps he expected unusual results from the comparison but instead he found similarities.

Since our task at Tulane is to equip students to practice in either a common law or a civil law jurisdiction, we believe that all students will benefit from the broad foundation furnished in an approach such as is found in Introduction to Property. The common law student is given a full introduction to property concepts as developed in the common law and is aware of the civil law method. The reverse may be stated for the civil law student. After his first year, the student is then equipped to continue with the course in Common Law Property if he intends to practice outside of Louisiana and with Civil Law Property if he intends to remain in Louisiana.

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Business Purchase Agreements Funded With Life Insurance

Address by Walter D. Freyburger
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delivered before the Joint Meeting of the Sections on Insurance and Taxation, Louisiana State Bar Association,
Biloxi, Mississippi, May 4, 1954

Agreements between partners or stockholders whereby each agrees that if he is the first to die his estate will sell his interest in the business to the survivors and agrees that if he survives he, or he and the other survivors, will purchase the interest of the decedent, are supported by mutual promises. Such agreements are not testamentary in character. Their validity is unquestioned. In 40 Am. Jur. 346, it is said "The right of partners to make agreements whereby the survivor shall have the right or option to purchase his deceased partner's interest in the firm on stated terms and conditions is unquestioned, and such agreements have been uniformly upheld and enforced by the courts, when made bona fide and supported by sufficient legal consideration."

In an excellent and exhaustive annotation in American Law Reports Annotated, Second Series, beginning at page 1178, entitled "Provisions for post-mortem payment or performances as affecting instrument's character and validity as a contract," at page 1265 the above quotation from 40 Am. Jur. is approved, and it is stated:

> "The same text states that agreements between partners that in the event of the death of one before the termination of the partnership, the survivor shall pay a certain amount to the legal representatives or heirs of the deceased partner and that thereupon he shall become the sole owner of the partnership business, are not open to objections when fairly made, for a valuable consideration and without any illegal purpose. Id. Par. 311. This clearly is the prevailing view, although notice is to be taken of a Rhode Island case, *Ferrara v. Russo* (1917) 102 A. 86, ruling a particular instrument of this type testamentary and not binding the surviving partner."

In that Rhode Island case the survivor was sued by the heirs at law of the deceased partner for failing to pay the purchase price set out in the partnership agreement. It was alleged that the agreement provided "that in the event of the death of Carmine Ferrara, then all of the said printing establishment was to become the property of the said defendent, and in consideration thereof the said defendant did then and there agree in writing with the said Carmine . . . that he would pay unto the heirs at law or the family, the sum of $275." The court held the instrument testamentary in character. It is the only case so holding that we have been able to find. This decision is no longer effective in Rhode Island due to legislation, Sec. 10, Chap. 428, General Laws of Rhode Island, 1938, added by P.L. 1932, Chapter 1862.

It must be noted that in the *Ferrara* case the interest of the decedent automatically passed to the surviving partner. No case has been found holding that such an agreement is testamentary which obligates the estate of the deceased partner to sell and the surviving partner to buy the interest of a deceased partner. This is clearly a contract which is to be performed upon the death of a deceased partner.

No case has been found in Louisiana bearing upon the validity of such agreements. However, in *McKnight v. Cornet,* 143 So. 726 (1932) an agreement which merely read "To whom it may concern. In the event of my death I agree to pay to W. McKnight the sum of six hundred dollars. A. S. Cornet" was held not testamentary in character. The court presumed that there was consideration for the promise.

Another Louisiana case which involved a partnership agreement provided that upon the death of a partner, the surviving partners should purchase the interest of the deceased partner, *Succession of Conway,* 215 La. 819, 41 So.(2d) 729 (1949), held that good will should be considered an asset in determining the purchase price to be paid under the terms of the agreement by the survivor. No question was raised as to the validity of the agreement.

In a very recent case, *Succession of Jurisich,* 60 So.(2d) 361 (decided December 14, 1953) the Supreme Court of Louisiana considered a partnership agreement which provided upon the death of either partner that the surviving partner was to have the right to buy the interest of the deceased partner at book

value. The suit was brought by the surviving partner to enforce this agreement. The only point of contention was whether the term "book value" included the value of good will when the books did not show any value for good will. The Court distinguished the *Conway* case, above mentioned, and held that the agreement did not require any compensation to be paid for good will. The Court said (p. 363):

> "There is nothing inequitable, however, in the provision of the partnership agreement which operated to exclude good will by giving to the surviving partner, upon the death of the other, the right and privilege of buying the interest of the deceased at its *then book value.* At the time the partners entered into the partnership agreement, neither gained any advantage by its insertion, as neither had any way of knowing which partner would die first.
>
> "This reciprocal clause was for the benefit of both and obviously was inserted so that upon the death of either the survivor might purchase for an easily acertainable amount the interest of the deceased and thus continue to operate the business without the delays and complications attendant upon appraisal and valuation of intangible assets."

In an interesting article entitled "Estate Planning in Louisiana," published in the Tulane Law Review, Feb. 1952, Vol. XXVI, beginning at page 119, John Minor Wisdom and Paul O. H. Pigman of the Louisiana Bar, after calling attention to questions that may arise as to testamentary character, forced heirships, and community rights, conclude:

"Recognizing these possible limitations under Louisiana law, agreements affecting valuation should be made if the agreement can be justified as reasonably required in a business venture and as not unfair to the community or to forced heirs, for only thus can a testator's disposition of business interests be made with comparative assurance concerning the valuation of these interests for purposes of estate taxation. In formulating the estate plan, proper evaluation of business interests either through use of an option agreement or through use of a realistic valuation formula will avoid unrealistic valuations which not only may result in unexpected tax burdens, but may entirely frustrate the estate plan."

It is submitted that if a contract provides for the estate of a deceased partner or shareholder to sell his interest in a partner-

ship or corporation to surviving partners or shareholders or to the corporation for a fair consideration, no gift being intended, then such an agreement should not be regarded as testamentary in character. With regard to the question of forced heirship, it does not seem that such agreements violate the rights of forced heirs as long as the consideration being paid by the purchasers of the partnership interest is fair and approximates the real value of such interest. In the usual situation it seems a forced heir has no prospect of retaining his proportion of the partnership interest but is only to receive his proportion of the fair value of such interest.

As regards the community interest of the surviving spouse, it would seem that the husband as the managing partner of the community should have authority to obligate the community, to sell the entire community interest in the partnership in the event of his death. However, it would seem advisable to have the agreements signed by the wife of each partner.

The validity of stock retirement agreements in general depends upon the power of the corporation under the laws of the state with respect to which it is incorporated, to purchase its own stock. Under English law, a corporation does not have the power to purchase its own stock. This rule continues to be followed in Canada. However, in the United States the majority of the courts take the view that a corporation may repurchase its own shares in the absence of statutory or self-imposed restrictions, if the purchase is made from surplus in good faith and without prejudice to creditors or other stockholders. See *Fletcher's Cyclopedia Corporations*, 1950, Rev. Vol. 6 A, section 2846, for a survey of the statutes and decisions relating to the validity of stock retirement agreements.

In Louisiana, it is provided in Section 23 of Title 12 of West's Louisiana Revised Statutes, Annotated, that unless the articles otherwise provide a corporation may purchase its own shares of any class issued by it, but only out of surplus available for dividends, and only if the purchase price does not violate the contractual right of any other class of shares. However, except in certain specified instances, the purchase must be authorized by an affirmative vote of two-thirds of the voting power of each class of shares outstanding.

It might be added that proceeds of life insurance should help to create a surplus.

If a corporation redeems a part of the stock of a stockholder, the amount paid in redemption may be taxable as a dividend. To be taxable as a dividend the stock must be redeemed "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend." The income tax regulations have long provided that the redemption of all of the stock of a particular stockholder, so that the stockholder ceases to be interested in the affairs of the corporation, does not affect a distribution of a taxable dividend (Reg. 118, Sec. 39.115-9). On the other hand, a redemption by a corporation of a portion of its stock pro rata among all the stockholders will generally be considered as effecting a distribution essentially equivalent to a taxable dividend. The regulations have been silent as to the effect of a redemption of a part of the stock of one stockholder. But until the law was amended in 1950 by adding paragraph (3) to section 115(g), any redemption of part of the stock of a decedent was considered dangerous. Paragraph (3) added by the Revenue Act of 1950, as amended by the Revenue Act of 1951, relieves a stockholder from being taxed under section 115(g) upon any amount received in redemption of stock not in excess of the estate and inheritance taxes (including interest collected as a part of such taxes) if the following conditions are met: (1) the value of the stock must be included in determining the value of the gross estate of the decedent; (2) the distribution must have been made within the period of limitations for the assessment of estate tax or within 90 days after the expiration of such period; and (3) the value of the stock in such corporation, owned by the decedent, for estate tax purposes, must comprise more than 35 per cent of the value of the gross estate of the decedent. If the above conditions are met, the estate of a decedent may sell a portion of the stock in the corporation owned by the decedent to the corporation, without being taxable as upon the receipt of a taxable dividend. If the estate sells all of the stock owned by the decedent, and the above conditions are not met, then under the existing regulations it would not be considered as receiving a taxable dividend.

It should be noted that although the heading for section 115(g) (3) is "Redemption of Stock to Pay Death Taxes," it is not necessary that the proceeds paid by the corporation for the redemption of stock be applied to pay death taxes. The decedent's estate may have other funds available to pay such taxes,

but nevertheless an amount may be received not in excess of estate and inheritance taxes in payment of stock redeemed by the corporation without the distribution being taxed as a dividend, provided the other requirements of section 115(g)(3) are met. It should also be noted that the stock redeemed not have been owned by the decedent at the time of his death and the redemption need not be from his estate. However, "the value" of the stock must be included in determining the value of his gross estate.

It should be noted also, that the amount distributed in excess of estate and succession taxes might be treated as a taxable dividend. The statute excepts from dividend treatment, "such part" of the distribution not in excess of death taxes. Thus a distribution may be both a dividend and a capital transaction. If stock of the surviving stockholders is also partially redeemed at the same time, such redemption might constitute a dividend to the surviving stockholders and a capital transaction as far as the estate of the decedent is concerned.

Since the law requires the distribution to be made within three years and ninety days after the estate tax return is filed, it is doubtful whether any payments made after that period, as in the case of periodic payments being made over a period of years, would get the advantage of section 115(g)(3). Such delay of payments would appear likely to be taxable as a dividend. One of the problems that might arise under section 115(g)(3), is the determination that the value of the stock owned by the decedent constituted more than 35% of the value of the gross estate outstanding. This involves questions of valuation of the assets of the estate, including the stock of the corporation. If there is a dispute as to such valuation, years may go by before the valuations are finally determined and it might make it unsafe to redeem the stock in the meantime.

Therefore, in close cases of valuation it may not be advisable to attempt to take advantage of section 115(g)(3). In addition to the question of valuation, there may be a question of whether certain property constitutes community or separate property. One difficulty in redeeming part of the stock may be that the estate of the decedent will lose control of the corporation. Consideration might well be given to a recapitalization or a dividend payable in non-voting preferred stock so that only such stock would be redeemed. If the stock is issued for the purpose of be-

ing redeemed, it may be well claimed by the Internal Revenue Service that the distribution in redemption is taxable as a dividend. However, see *Chamberlin v. Comm'r,* 207 F.(2d) 462 (Sixth Circuit, 1953), in which it is held that although preferred stock was issued for the purpose of having the shareholder sell such stock to insurance companies and although the corporation under a formula depending on net earnings was to retire all the shares over a period of eight years, that the inssuance of the preferred stock as a dividend did not constitute a taxable dividend. The Court relied upon the Supreme Court case of *Strassburger v. Comm'r,* 318 U.S. 604 (1943). However, this decision is the subject of a critical note in the Harvard Law Review, January, 1954, Page 520. It should be noted that the proposed Internal Revenue Code of 1954 is making drastic changes in what now constitutes section 115(g), and while these proposed changes are now being reviewed with likelihood of amendment, it is expected that the new law will clear up many of these uncertainties. See Sections 301 to 312 of H.R. 8300.

It should be noted that H.R. 8300, Internal Revenue Code of 1954, as it passed the House, liberalized the existing provisions of section 115(g)(3). Sec. 303 of the bill would make what is now section 115(g) (3) applicable to a situation where either the value of the stock for estate tax purposes comprises more than 35 per cent of the value of the gross estate of the decedent, or where the value comprises more than 50 per cent of the net estate of such decedent. The amount to be paid for such stock may include an amount sufficient to pay funeral and administration expenses, as well as estate and inheritance taxes.

Another change which is proposed by the new Internal Revenue Code is that if the decedent owns stock in two or more corporations and there is included in his estate with respect to each corporation more than 75 per cent in value of the outstanding stock, then the stock in such corporations shall be treated as the stock of a single corporation.

The problem of valuing the interest of an individual in a business, whether it is a sole proprietorship, partnership, or close corporation, is usually a difficult one. There has been much litigation with respect to such values in determining estate taxes. A number of very valuable articles have been written on this subject in recent years.

Consider first the case where there is no business purchase

agreement. How should the executor in making out the estate tax return determine the value? What position is the internal revenue agent likely to take?

The executor may use the net worth basis of the assets of the business. He would start with the book value, and make adjustments to reflect the actual values as of the date of the death of the decedent. If the accounting has been very conservative, a much lower valuation may be shown than will be acceptable to the revenue agent. On the other hand, some assets may not be worth the book value. Attention must be given to the proper value of such items as inventories, accounts receivable, and plant and equipment. If the business is to be liquidated, the cost of the liquidation should be deducted from the book value. Prior earnings would appear as relatively immaterial if the business is to be liquidated.

In valuing the interest of the decedent in a sole proprietorship or partnership, the Treasury Regulations provide: "A fair appraisal as of the applicable valuation date should be made of all of the assets of the business, tangible and intangible, including good will, and the business should be given a net value equal to the amount which a willing purchaser, whether an individual or corporation, would pay therefor to a willing seller in view of the net value of the assets and the demonstrated earning capacity. Special attention should be given to fixing an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest therein shall pass at his death to his surviving partner or partners." The Regulations further provide: "All evidence bearing upon such valuation should be submitted with the return, including copies of reports in any case in which examinations of the business have been made by accountants, engineers, or any technical experts as of or near the applicable valuation date." (Reg. 105, Sec. 81.10(i).

In the case of a close corporation where actual sales or bona fide bid and asked prices are not available the Treasury Department Regulations provide that the value of stock in such corporations is to be arrived at "upon the basis of the Company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Among such other relevant factors to be considered are the values of securities of corporations engaged in the same or

a similar line of business which are listed on an exchange. However, the weight to be accorded such companies or any other evidentiary factors considered in the determination of a value depends upon the facts of each case." (Reg. 105, Sec. 81.10(c)).

It appears from the various court decisions* that the value of the business interest as set out in the agreement or as determined in accordance with a formula set out in such an agreement, will be determinative for estate tax purposes, if the following conditions are met:

1. The agreement is the result of an arm's length transaction.
2. The agreement requires the estate to sell.
3. The surviving party or parties have a legally binding contract or option to purchase.
4. The decedent could not have disposed of his interest during his lifetime without first offering it to the other party at a price not higher than the price to be paid had the sale been made by his estate to such other party.

The term "arm's length transaction" means that in fixing the price and the terms for the sale of an individual's interest in the business at the time of his death, the parties must deal with each other as they would with strangers. There must be no donative intent. The price agreed upon should be the result of bargaining by the parties who are concerned with securing a fair price for the interest of the decedent and are informed as to the present value of the business and prospects for future earnings. If a fixed price is agreed upon, and it is a fair price at the time from an objective point of view, but the parties neglect to readjust the price as time goes on, there may be a question whether that price will be determinative for estate tax purposes. While the estate will not be able to get a higher price than that fixed in the agreement, and there are numerous cases that have been upheld, the agreed price for estate tax purposes, it is possible that

*Wilson v. Bowers, 57 F.(2d) 682 (C.C.A. 2d 1932); Lomb v. Sugden, 82 F.(2d) 166 (C.C.A. 2d 1936); Rose Newman, Executrix, 31 B.T.A. 772 (1934) acq. XIV—1 C.B. 14; Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938) acq. 1938—1 C.B. 20; Comm'r v. Bensel, 100 F.(2d) 639, affg. 36 B.T.A. 246 (C.C.A. 3rd 1938); John Q. Strange Est. B.T.A. Memo Dec. P-H Decision No. 42,247; Estate of Henry A. Maddock, 16 T.C. 324, (Acq. I.R.B. 1951-19,1); Estate of Albert L. Salt, 17 T.C. 13 (Acq. I.R.B. 1952-1,1); May v. McGowan, 194 F.(2d) 396 (C.C.A. 2d 1952); see also Theodore Ness, 49 Col. L.R. 796 (1949). But see Estate of George M. Trammell, 18 T.C. No. 77 (1952) in which the agreed valuation which expressly left out good will was not accepted for estate tax valuation purposes.

a court will reason that the parties to the agreement cannot arbitrarily fix the value for all time, to the detriment of the revenue. It is therefore advisable that such fixed price be reexamined by the parties at frequent intervals. It is also recommended that the parties retain data showing how the price was determined; if good will was considered, how it was valued; if no good will was included in the valuation, the reason for such omission. It is possible that the loss of services of the decedent would more than offset the value of any good will.

In a recent Tax Court case, *Estate of George M. Trammell*, 18 T.C. 662 (1952) the agreed valuation which expressly left out good will was not accepted for estate tax valuation purposes.

The present position of the Internal Revenue Service with respect to the effect of restrictive agreements is set out in Revenue Ruling 54-77, as follows:

"Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life, as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. When the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than adequate and full consideration in money or money's worth."

In order for any of the proceeds of life insurance payable to beneficiaries other than the estate of the insured to be included in the gross estate of the decedent, the Federal law provides that either: (1) the insured must have retained some incidents of ownership at the time of his death, either alone or jointly; or (2) the insured must have paid some of the premiums either directly or indirectly. Generally speaking, if the insured retained no incident of ownership and paid only part of the premiums, then only a part of the proceeds in proportion to the total pre-

miums paid by the insured would be in proportion to the total premiums paid by the insured would be taxable. If the insured transferred the policy at such time and under such circumstances than the transfer is considered as made in contemplation of death.

If we assume the existence of a partnership purchase agreement, which provides that upon the death of any partner, the proceeds of life insurance owned by the partnership on the life of such partner shall be applied to purchase his interest in the business, then only an amount equal to the purchase price of his interest should be included in his estate. If the insurance or part of it is included in his estate under the premium payment or incident of ownership test, then since the deceased partner has sold his interest for such insurance proceeds, or such proceeds and additional amounts, only such additional amounts would be included in his estate. As the Board of Tax Appeals stated in the *Dobrzensky* case, 34 BTA 305 (1936):

> "Obviously, the decedent could not be taxed with an asset, as his own, at death, and, at the same time, taxed with the consideration he relinquished for that asset."

The Bureau of Internal Revenue has indicated that if insurance is taken out by partners on the life of each other under a valid buy-and-sell agreement and is made payable, in each instance, to the wife of the insured, with the proceeds to be applied toward payment for the insured's partnership interest, in the event of his death, the insurance and the full value of the partnership interest will not be both includible in the gross estate of the decedent. Press Memo, Nov. 24, 1947. The Tax Court in the *Dobrzensky* case, 34 BTA 305 (1936), the *Mitchell* case, 37 BTA 1 (1938), the *Tompkins* case, 13 T.C. 1054 (Acq. 1950-1 Cum. Bull. 5), and the *Ealy* case, 10 T.C.M. 431, has refused to tax both the insurance proceeds payable for a decedent's interest in the partnership or corporation and the value of such interest exchanged for such proceeds .

In a closely held corporation, there is fear in some quarters that the payment of premiums by the corporation may constitute the payment of dividends to the stockholders. This fear does not appear well founded. The corporation is the owner of the policies and is entitled to the cash surrender values, etc. A corporation is a separate entity. It is difficult to tell which stockholders, if any, will survive and obtain the advantage of the insurance. En-

tirely new stockholders may own the company when the proceeds of insurance are collected. Moreover, the ownership of insurance on the lives of shareholders in a close corporation fills a corporate need. It is in the interest of the company to have harmony in management, and therefore keep control in the existing stockholders. There have been no court decisions to date taxing the stockholders on the constructive receipt of dividends for premiums paid where the corporation owned the policies. Apprehension has also been expressed that when stock is retired, the remaining shareholders may be considered as receiving a dividend. But that principle, if applied, would result in taxable dividends to shareholders whenever a corporation retired any of its stock under any circumstances.

Upon a review of recent court decisions, George J. Laikin, in an article in the Chartered Life Underwriter's Journal of December, 1952, concluded:

> "On the basis of the foregoing discussion, it may safely be concluded that a corporation may acquire insurance upon the life of a sole or dominant stockholder without involving the sole stockholder in estate or income tax dangers, provided (1) the corporation is the applicant for the insurance; (2) it holds all of the incidents of ownership; (3) it is the beneficiary; (4) it pays all of the premiums; (5) the insurance serves a corporate and business purpose; and (6) the insured has no rights in the policy or the proceeds."

See also Taxes, May, 1950, an article by Albert Mannheimer and Joel Friedman.

These conclusions were based principally upon two United States Supreme Court decisions, *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943) and *National Carbide Corporation v. Commissioner*, 336 U.S. 422 (1949). In the *Moline Properties, Inc.* case the court said:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

The facts here were: Petitioner corporation was organ-

ized in 1928 by Thompson as a security device suggested by the mortgagee of certain property. Thompson conveyed the property to the corporation in return for all the stock, and transferred the stock to a trustee as security for several loans. The loans were repaid, and eventually some of the property was sold by the corporation at a profit, as assessed and then asked for a refund on the ground that the profit should be taxed to Thompson individually and not to the corporation.

The exception to this general rule was also stated by the court in Moline Properties, as follows: (319 U.S. 436, 62 S.Ct. 1132).

"In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction."

In the National Carbide Corporation case, the court said:

"So far as control is concerned, we can see no difference in principle between Airco's control of petitioner and that exercised over *Moline Properties, Inc.*, by its sole stockholder. Undoubtedly the great majority of corporations owned by sole stockholders are 'dummies' in the sense that their policies and day to day activities are determined not as decisions of the corporation but by their owners acting individually. We can see no significance (in this) . . . We reversed the Board of Tax Appeals in *Moline Properties* in the face of its findings that 'Full beneficial ownership was in Thompson (the sole stockholder) who continued to manage and regard the property as his own individually.' "

The Court further stated:

". . . Complete ownership of the corporation and the control primarily dependent upon such ownership . . . are no longer of significance in determining taxability."

One case sometimes cited to show the danger of a corporation paying premiums on policies to fund stock retirement agreements is the *Paramount-Richards* case, 153 F.(2d) 602 (1946). In that case, a movie company and Richards agreed to form a corporation. The stock was to be divided equally between them. Richards was to manage the company for a fixed salary. The stockholders were to cause the corporation to insure Richards' life for $250,000, if he proved to be insurable at standard rates. Richards' estate, or his designee, was to be the beneficiary. If Richards died, the movie company was to have the option to buy Richards' stock at a stipulated price. However, if the insurance had not been procured on Richards' life, then $125,000

— one-half of the amount of the proposed insurance — was to be added to the price to be paid to Richards' estate for his stock. The corporation was formed, the stock issued and the insurance procured. The main question in the case was whether the premiums should be regarded as additional compensation to Richards or as dividends. Since the insurance was obviously designed to benefit, not only Richards, but also the movie company, the premiums were held to be dividends.

What the stockholders did, to quote the Circuit Court of Appeals opinion in the case, "was to appropriate corporate funds to their joint benefit by the premium payments." The corporation was not a party to the agreement. It had neither opportunity nor obligation to buy Richards' stock in case he died. In no circumstance was it to receive any of the proceeds of the insurance on Richards' death.

Sec. 102 I.R.C. imposes an additional tax upon the net income of a corporation which is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders, through the medium of permitting earnings or profits to accumulate instead of being distributed. May the purchase of life insurance for the purpose of buying the shares of a deceased shareholder give rise to a section 102 tax?

Is the purchase of its own stock by a close corporation from the estate of a deceased shareholder "unrelated to the normal business activities" of the corporation? The United States Court for the Third Circuit in the *Emeloid* case, 189 F.(2d) 230, in referring to such a stock retirement agreement and pointing out that the purpose of the agreement was to provide for continuity of harmonious management, said "Petitioner apparently anticipated that, should one of its key stockholder-officers die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by contract to sell the stock to petitioner, might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals." If life insurance is purchased to fund a stock retirement agreement in order to provide for continuity in the management and general policies of the company, then under the reasoning of the *Emeloid* case the purchase of insurance for such purpose should be regarded as a purchase for the welfare of the corporation and not be evidence of the accumulation of profits

not needed in the business of the company.

If part only of the stock is redeemed under section 115(g) (3) for the purpose of paying estate and inheritance taxes, Congress by enacting such a provision would appear to have approved a reasonable funding arrangement, such as the purchase of ordinary life insurance by the corporation. Carrying out a program approved by Congress would not seem to give rise to a violation of section 102. However, the facts in each case must be considered in determining whether the corporation is vulnerable to a section 102 tax.

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